POLITICAL INFLUENCES AND EARNINGS QUALITY: EVIDENCE FROM PAKISTAN

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POLITICAL INFLUENCES AND EARNINGS QUALITY: EVIDENCE FROM PAKISTAN

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ABSTRACT

The general objective of this study was to examine the relationship between political influences and earnings quality. Specifically, this study examined the relationship between the ruling party politically connected firms and poor earnings quality. In addition, the study also compared the opposition party politically connected firms, when politically influenced firms substitute real earnings management for accrual earnings management in Pakistan. This study used the data of 129 firms listed on the Pakistan Stock Exchange over the period 2009-2013. The Panel Corrected Standard Error (PCSE) technique was employed to solve the heteroskedasticity issue. The results showed that politically influenced firms are reporting poor earnings quality. Contrary to previous studies, politically connected firms through opposition party(s) report poor earnings quality compared to ruling party(s) politically connected firms, when earnings quality is measured by the real earnings management attribute of earnings quality. However, there is no difference between the ruling party and the opposition party political connections on earnings quality, when earnings quality is measured by the accrual earnings management attributes of earnings quality. The study also found that politically influenced firms substitute real earnings management for accrual earnings management. Further, this study revealed that firms with stronger political connections are more involved in accrual earnings management activities and firms with weaker political connections are more inclined to use the real earnings management strategy. Accordingly, regulators must keep in mind political factors during regulatory reforms. This study provides detailed investigations and deep insight on the relationship between political influences and earnings quality. This study contributes to the field of earnings management where it integrates the agency theory with the political economy theory. Apart from that, this study contributes to practice where it provides deep insight to policy- makers who are interested in improving corporate governance in Pakistan.

Keywords: political influences, earnings quality, earnings management, Pakistan.

ABSTRAK

Objektif am kajian ini adalah meneliti hubungan antara pengaruh politik dan kualiti pendapatan. Secara khususnya, kajian ini meneliti hubungan antara firma yang mempunyai kaitan dengan parti politik pemerintah dan kualiti pendapatan yang lemah. Di samping itu, kajian ini juga membuat perbandingan antara firma yang mempunyai kaitan dengan politik dengan parti lawan di Pakistan. Ini apabila firma menggantikan pengurusan pendapatan pilihan dan apabila firma mengunakan pengurusan pendapatan akruan. Kajian ini menggunakan data daripada 129 buah firma yang disenaraikan dalam Bursa Saham Pakistan dari tahun 2009 hingga2013. Teknik *Panel Corrected Standard Error (PCSE)* digunakan untuk menyelesaikan masalah *heteroscedasticity*. Kajian mendapati firma yang mempunyai pengaruh politik melaporkan kualiti pendapatan yang lemah. Hal ini berbeza dengan kajian terdahulu iaitu firma yang mempunyai pengaruh politik daripada pihak lawan melaporkan kualiti pendapatan yang lemah apabila kualiti pendapatan diukur menggunakan pengurusan pendapatan sebenar sebagai atribut kualiti pendapatan. Walau bagaimanapun, kajian juga mendapati tiada kesan perhubungan antara parti pemerintah dan parti lawan apabila kualiti pendapatan diukur menggunakan pengurusan pendapatan akruan sebagai atribut kualiti pendapatan. Kajian juga mendapati firma yang mempunyai pengaruh politik, melaporkan pengurusan pendapatan sebenar berbanding dengan pengurusan pendapatan akruan. Justeru6, kajian juga mendedahkan bahawa firma yang mempunyai pengaruh politik yang kuat, melibatkan diri dengan aktiviti pengurusan pendapatan akruan dan firma yang mempunyai pengaruh politik yang lemah lebih cenderung kepada pengunaan strategi pengurusan pendapatan sebenar. Oleh itu, pihak berkuasa perlu mengambil perhatian akan hubungan politik apabila membuat reformasi terhadap penguatkuasaan. Secara keseluruhannya, kajian ini memberi penelitian yang terperinci dan mendalam akan perhubungan antara firma politik dan pengurusan pendapatan. Kajian ini menyumbang kepada pengurusan pendapatan apabila menghubungkaitkan teori agensi dengan teori ekonomi politik. Selain itu, kajian ini juga menyumbang kepada praktis apabila memberi maklumat yang mendalam kepada pembuat polisi yang berminat dalam menambah baik tataurus tadbir di Pakistan.

Kata kunci: pengaruh politik, kualiti pendapatan, pengurusan pendapatan, Pakistan

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AEM	Accruals Earnings Management
BIG4	The 4 largest audit firms worldwide, Deloitte, KMPG, PricewaterhouseCoopers, and Ernst & Young
BUR	Presence of Civil/Military Bureaucrat(s) on Board of Directors
EA	Earnings Aggressiveness
EQ	Earnings Quality
FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principles
GOVT	Government Owned Firms
IFRS	International Financial Reporting Standards
PC	Political Connections
PCR	Political Connections through Ruling Party
PCSE	Panel-Corrected Standard Errors
PI	Political Influences
REM	Real Earnings Management
SECP	Security Exchange Commission of Pakistan
SOX	Sarbanes-Oxley Act, the United States

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CHAPTER ONE

INTRODUCTION

1.1 Background

The top management of an organization communicates firms' performance to its stakeholders through financial reports or annual reports, which allows the stakeholders to differentiate between good performing and poor performing firms. However, this can only be reliable guide when the firms are reporting their earnings in a credible or reliable way (Dechow and Schrand, 2004). The managers communicate about firm performance in financial reporting, and accounting standards allowed managers to use their judgments in reporting. This gives discretions to the managers to choose reporting technique that truly reflects the economic transactions of business. However, the discretions may also give opportunities to managers to misuse it, and get involved in earnings management activities (Healy and Wahlen, 1999).

Schipper (1989) defines earnings management (earnings manipulation) activities as the purposeful intervention in financial reporting, with the intent of getting some private gain. There are also empirical evidences that highlight some factors that motivate firms to get involved in earnings management. For example, Dechow and Schrand (2004) highlight factors which encourage firms to get engaged in managing earnings; such as issuing shares at high prices, meeting analysts and investors' expectations and reducing cost of acquiring new capital etc. In addition, Healy and Wahlen (1999) have also discussed several methods adopted by the firms to managed earnings i.e. overstating

assets, revenues and profits, understating earnings per share, premature revenue recognition, aggressive capitalization, changing depreciation and amortization policies, underreporting expenses and liabilities, fictitious revenue recognition and overstating cash flows. Previous studies show that earnings management activities decrease the earnings quality.

Earnings quality is contextual and it means different things to different people. Prior studies exemplify that high earnings quality contain small amount of accruals (Sadiq and Othman, 2017; Bhattacharya, Daouk, and Welker, 2003), give a useful measure for assessing firms values (Dechow and Schrand, 2004), earning is predictable and persistent (Penman and Zhang, 2002). On the contrary, earnings quality problem arises when firms get involved in earnings management activities (Al-dhamari and Ismail, 2015), and report less transparent earnings (Bhattacharya, Daouk, and Welker, 2003).

The significance of high earnings quality has long been recognized since still there are many firms that are involved in earnings management activities, and reporting poor earnings quality. For example, Toshiba and Valeant Pharmaceutical was reported to be involved in activities like overstating earnings, postponing reporting losses, moving current year costs to later years, and inflating sales (Fortune, 2015). Other infamous earnings management scandals include Penn West Petroleum Ltd., Tesco, Satyam, Tyco international and HealthSouth. Penn West Petroleum Ltd moved millions of dollars from revenue expenditure to capital expenditure, which artificially reduced 20 percent of their operating expenses (Reuters, 2017). Tesco was found involved in earnings

management practices by reporting inflated profits (Telegragh, 2017). Satyam was involved in overstating its reported earnings, assets and also paying salaries to non-existing staff for several years. WorldCom on the other hand used a simple method to capitalize more than $11 Billion of expenditures as assets rather than expenses. It was also involved in underreporting expenses and inflating revenues through fake accounting entries. A Switzerland based company named as Tyco international was found involved in inflating income by its CEO and CFO. In Australia, HealthSouth was caught by Security exchange commission which was found inflating $1.4Billion earnings to meet its shareholders expectations.

Pakistan is not excluded in respect of earnings quality; scandals have engrossed firms such as Tandlianwala Sugar Mills, Chenab Limited, Callmate Ltd, NICL and OGRA are all linked to earnings quality issues (Dawn, 2015; Tribune, 2014; SECP, 2010; Dawn, 2008). The earnings quality gets worse when firms are politically influenced (Sadiq and Othman, 2017; Al-dhamari and Ismail, 2015). A firm is considered as politically influenced in presence of politician(s) or close relative(s) of a politician(s) in a board or senior management; a firm is significantly owned by the government; and in presence of civil/military bureaucrat(s) in a board.

Security Exchange Commission of Pakistan (SECP) reported that a politically influenced firm named Chenab Limited was involved in manipulating share prices or artificially increasing share prices (SECP, 2010). On the other hand, Dawn newspaper reports that National Accountability Bureau (NAB) of Pakistan has started investigating

against a politically connected firm named Tandlianwala Sugar Mills (Dawn, 2015). NAB accused Tandlianwala Sugar Mills for involving in suspicious transactions. Similarly, CallMate was found involved in fraudulent practices such as reporting fictitious revenue or manipulated revenue (Dawn, 2008).

In addition, a politically influenced firm named National Insurance Company Limited (NICL) was involved in buying properties more than the market value by giving benefits to politically connected people (Dawn, 2015). Further, the former Chairman and Directors of Oil and Gas Regulatory (OGRA) were engaged in manipulating earnings and share prices of Sui Northern Gas Pipeline (SNGPL) and Sui Southern Gas Company (SSGC) (Tribune, 2014). The Express tribune also reported that former Prime Minister Yousuf Raza Gillani and minister Raja Pervaiz Ashraf were also summoned for illegally appointing the chairman of OGRA. All these facts show that there is a strong nexus between politics and businesses in Pakistan.

Realizing the seriousness of earnings quality issues, regulatory bodies from many developed and developing countries realized and revamped the laws related to accounting practices. For example, the implementation of Sarbanes-Oxley Act (SOX) in 2002 was one immediate response to earnings quality soon after Enron scam. Some authors opine that accrual based earnings management (AEM) was reduced substantially after the implementation of SOX (Braam, Nandy, Weitzel, and Lodh, 2015; Cohen, Dey, and Lys, 2008), indicating the success of the revamping of the rules and regulations related to earnings management.

Prior studies have determined factors that influence the quality of earnings such as ownership and capital structure (Ben-Nasr, Boubakri and Cosset, 2015; Soderstrom and Sun, 2007), accounting methods (Altamuro, Beatty, and Weber, 2005), corporate governance (Zhao, Chen, Zhang and Davis, 2012; Lin and Hwang, 2010; Cohen, Krishnamoorthy, and Wright, 2004), corporate social responsibility (Kim, Park, and Wier, 2012), audit quality (Lin and Hwang, 2010; Prawitt, Smith, and Wood, 2009). Significantly, some authors opine that corporate political influences are a global phenomenon and it creates complex economic consequences (Bleibtreu and Königsgruber, 2015).

Previous studies even documented that earnings quality gets worse when firms are politically influenced (Chi, Liao, and Chen, 2016; Liu, Li, Zeng, and An, 2016; Al-dhamari and Ismail, 2015; Liu, Saidi and Bazaz, 2014; Narayanaswamy, 2013; Chaney, Faccio, and Parsley, 2011). Ironically, in recent years political influences have become a common phenomenon (Saeed, Belghitar, and Clark, 2015), which is evident in the study of Zang (2011), who disclosed that 54.5 percent of the firms in their sample had politically influenced senior management in 2007 compared to 31.5 percent in 1990. Such trend is also noted in developing countries where political connections are valuable for firms operating in economies where institutions are weak and politicians have no fear of accountability.

Fisman (2001) shows how firms that have close connections with politically connected people get favors. He cites the example that before the news of Indonesian President Suharto's bad health was publicly released, firms linked with President Suharto's family had already known about it while other viewed it as spread of rumors. Roberts (1990) finds out that in 1983 firms that contributed in elections campaign of Senator Henry Scoop Jackson, unexpectedly find their stock returns dropping after his sudden death. At the same time, firms connected to Senator Sam witnessed unexpected increase in stock returns who was the successor of Senator Henry.

Moreover, it is also noticed that in developing economies politically influenced firms get favored bank loans at a lower interest rate and higher debt ratio. This view is supported by a number of empirical evidences. For instance, Charumilind (2006) find that political influences are an important determinant in Thailand to get a long-term financial leverage. Similarly, Khwaja and Mian (2005) reveal that politically influenced firms are determined by a lower interest rate and higher debt equity ratio. Some researchers argue that political connection negatively affects earnings quality (for example, Al-dhamari and Ismail, 2015; Chaney, Faccio, and Parsley, 2011), while other researchers opine that politically influenced firms have additional power beyond country specific, regulatory and firm-specific ownership characteristics (e.g. Faccio, Masulis, and McConnell, 2006).

There is also empirical evidence proving that political influences are more common in countries with high corruption and less common in countries where strict regulations are

practiced and there exists political conflicts of interest (Faccio, 2006). Pakistan for instance, labeled as one of the most corrupted countries in Asia, is associated with corruption, power abuse and bribery (Saeed, Belghitar, and Clark, 2015). As a matter of fact, the Index of Economic Freedom has named Pakistan as amongst the top corrupt countries of the world (Saeed, Belghitar, and Clark, 2015). As evidence, during the last 25 years three elected prime ministers have been removed and four elected parliaments have been dissolved on charges of corruption and political abuse of power. Since the independence of Pakistan, business and politics in Pakistan have a very close association (Rehman, 2006). The first Chief Minister of Sindh province named Yousuf Haroon was one of the leading industrialists, and people like Naseer Shiekh and Rafiq Saigol were the founding owners of Saigol Group, and Ahmad Dawood (owner of Dawood group) held main positions in the governments (Rehman, 2006). In the general elections held in 2002, 2008 and 2013, the political parties that participated were mainly led by politicians representing some of the country's top industrialists (Cheema, Munir, and Su, 2016; Saeed, Belghitar, and Clark, 2015).

In these elections, a large number of Parliament members belonged to families that owned large business firms and groups, such as the Ittefaq Group of Nawaz Sharif family, current prime minister of Pakistan while chief minister of Punjab too belongs to this family. Besides, there are business groups such as Saif Group of current Senator Usman Saifullah, Salim Saifullah Khan, and Anwar Saifullah Khan, former Provincial and Federal Ministers; JWD group of Jahangir Khan Tareen, former Federal Minister and current member of National Assembly; Service Industries of Ahmad Mukhtar,

former Defense Minister, Mirza Sugar Mills of Zulfiqar Mirza, former Interior Minister of Sindh Province; Masood Textile Ltd of Shahid Nazir, member of the National Assembly during 2002–2007 and Tandlianwala Sugar Mills Ltd of Haroon Akhtar Khan and Humayun Akhtar Khan, former Ministers, and Media times and Worldcall of Salman Taseer, former Governor of Punjab (Saeed, Belghitar, and Clark, 2015). In a country where businessmen are significantly involved in politics and politicians have their own business interests, it is difficult to separate business interests from the interests of the state. Traditionally, it is understood that politically influenced firms misuse resources on a large scale through the abuse of their political influences and state power.

Reviewing the previous literature notably, there is a clear evidence which indicates the relationship between political influences and earnings quality (e.g., Sadiq and Othman, 2017; Chi, Liao, and Chen, 2016; Al-dhamari, and Ismail, 2015; Liu, Saidi, and Bazaz, 2014; Chaney, Faccio, and Parsley, 2011). Some authors argue that politically influenced firms are more involved in manipulating earnings, and reporting poor earnings quality. For example, Sadiq and Othman (2017); Al-dhamari and Ismail (2015) find that politically influenced firms have lower accruals quality; they are more engaged in earnings smoothing (Liu, Saidi, and Bazaz, 2014), and reporting less transparent earnings (Riahi-Balkaoui, 2004). Other researchers opine that politically influenced firms are involved in income-decreasing earnings management activities in order to report less taxable income (Li, Selover, and Stein, 2011; Ramanna and Roychowdhury, 2010), and hiding political gains which they obtain through dubious legality (Sadiq and

Othman, 2017; Chaney, Faccio, and Parsley, 2011). However, to the best of knowledge, none of the study has investigated political influences and earnings quality using three aspects of political influences and three attributes of earnings quality, which includes both accruals and real earnings management attributes of earnings quality. This is because; including only one attribute i.e. accruals or real earnings management underestimates earnings management activities of a firm. Therefore, this study adopted both accruals earnings management and real earnings management attributes in order to estimate and capture all earnings management activities of a firm, and thus gives more insight on the relationship between political influences and earnings quality.

Pakistan has numerous unique characteristics of politically influenced firms, which provided the opportunity to examine the impact of political influences on earnings quality in Pakistan. First, prior studies have used political influenced firm in a limited sense, where firm is assumed to be a politically influenced if it is affiliated with a single powerful politician (i.e. Dr. Mahathir and Dr. Anwar Ibrahim in Malaysia and Suharto in Indonesia). Unlike in Pakistan, there is a high presence of politicians and their close relatives in firms. In fact, political system of Pakistan is controlled by influential families and business conglomerate (Saeed, Belghitar, and Clark, 2015), which is unlikely witnessed in previous studies. Secondly, congruent with the study of Cheema, Munir, and Su (2016), this study contributes to the agency theory and political economic theory by including another aspect of political influences (i.e. the presence of civil/military bureaucrats in a firm). This is because; Pakistan has directly been ruled by civil/military bureaucrats for couple of decades, which make these bureaucrats equally

influential as politicians. Thirdly, politically influenced firms of Pakistan provide a distinctive characteristic of data by offering almost equal number of ruling and opposition party of politically connected firms. This is because, ruling party(s) has generally faced a strong opposition party(s) in Pakistan which provides the opportunity to investigate whether political connected ruling party firm report earnings quality poorer than a political connected opposition party firm. Fourthly, there is a strong nexus between politics and business in Pakistan, and numerous scandalous politically influenced firms are named of manipulating earnings as mentioned earlier. However, limited empirical evidence is available on the issue. Therefore, this study is motivated to give more insight on the relationship between political influences and earnings quality, and thus quantitatively investigated the impact of political influences on earnings quality in Pakistan.

1.2 Problem Statement

It has been observed that earnings quality is high when earnings numbers truly reflect firm's current performance (Dechow and Schrand, 2004); they are free from earnings management (Chaney, Faccio, and Parsley, 2011; Barth, Landsman and Lang, 2008), and contain high transparency (Sadiq and Othman, 2017; Bhattacharya, Daouk, and Welker, 2003). Consequently, financial statement users can make a well informed decision when firms are reporting high earnings quality, which reflects true and fair value of the firm (Dechow and Schrand, 2004). The above scenario is not met when firms' managers are engaged in earnings management to achieve desirable results but end up with lower earnings quality.

Managers often involve in earnings management to hide and cover the real performance of a firm (Braam, Nandy, Weitzel, and Lodh, 2015; Chaney, Faccio, and Parsley, 2011; Teoh, Welch, and Wong, 1998). Consequently, the occurrence of earnings management deteriorates the reliability of earnings numbers, which results in unpredictable, non-sustainable, and less transparent earnings.

The above scenario gets worse when firm is politically influenced, creating agency problem and revealing that politically influenced firms are more involved in earnings management activities and reporting poor earnings quality (Sadiq and Othman, 2017; Chi, Liao, and Chen, 2016; Braam, Nandy, Weitzel, and Lodh, 2015; Chaney, Faccio, and Parsley, 2011). This is because politically influenced firms are involved in tax-induced earnings management activities (Li, Selover, and Stein, 2011), obtaining political benefits through dubious legality (Chaney, Faccio, and Parsley, 2011), and then cover those political benefits by getting involved in income-decreasing earnings management activities (Ramanna and Roychowdhury, 2010), and thus report poor earnings quality.

Pakistan is not an exception in respect of political influences and earnings quality; there is a nexus reported between politics and business; there are scandalous firms and companies as mentioned above that direct and monitor most of the political and business fortunes of the country.

Due to seriousness of the issue and consequent to its impact on shareholders, researchers have suggested studies to be conducted to examine the impact of political influences on earnings quality. For instance, Sadiq and Othman, 2017; Chi, Liao, and Chen, 2016; Al-dhamari and Ismail (2015) suggest that political influences and earnings quality need to be investigated in more detail using different aspects of both variables. Although there are studies that have investigated the correlation between politically influenced firms and earnings quality, very little focus was given to investigate the relationship between politically influenced firms and earnings quality in comparison to non-politically influenced firms using multiple aspects of political influences and multiple attributes of earnings quality.

Given the importance of the issue, seriousness of the consequences and impact of the issue to many stakeholders, this study will use three aspects or types of political influences simultaneously to investigate political influences and earnings quality: first, presence of politician(s) or close relative(s) of a politician(s) in board of directors or senior management; second, significant government shareholding in a firm; third, presence of former/current civil/military bureaucrat(s) in board of directors or senior management) and three attributes of earnings quality (i.e. Real earnings management, accruals earnings management, and earnings aggressiveness). The regulatory bodies and conflict of interest laws are weak in Pakistan, which allow powerful politicians and their close relatives, and civil/military bureaucrats to manipulate things and obtain private gains (Cheema, Munir, and Su, 2016).

As mentioned, the impact and consequences of the issue is tremendous. Political influences are considered to be an important determinant of the Asian economies (Harymawan and Nowland, 2016; Chi, Liao, and Chen, 2016; Gul, 2006; Fisman, 2001), and particularly in Pakistan (Sadiq and Othman, 2017; Cheema, Munir, and Su, 2016; Saeed, Belghitar, and Clark, 2015; Khwaja and Mian, 2005). Considering the issue, current study provides a detailed investigation regarding the relationship between political influences and earnings quality in Pakistan, because Pakistani firms provide diversity in the data of politically influenced firms. In Pakistan, there is a high presence of civil/military bureaucrats, politicians from ruling/opposition parties and their closed relatives in firms, which offers useful variation in terms of the type of political influences that is used to examine the phenomenon. The study used politically influenced and similar non-politically influenced listed firms in Pakistan Stock Exchange (PSE) in order to get a clear picture of earnings quality in each of the firms, and to quantitatively investigate in detail the effects of political influences on earnings quality.

1.3 Research Questions

Based on the above research problem, which is to provide a detailed investigation regarding the relationship between political influences and earnings quality in Pakistan. This study addressed a few fundamental questions:

1) Is there a negative relationship between political influences and earnings quality?

2) Does a politically connected ruling party firm report earnings quality poorer than a politically connected opposition party firm?

3) Do politically influenced firms substitute between earnings management strategies?

1.4 Research Objectives

This study used politically influenced listed companies of Pakistan in order to get a clear picture of earnings quality in each of the firm, and to quantitatively investigate the effects of political influences on earnings quality. To achieve this, the study has general and specific objectives. Following are the objectives of the research:

1) To examine whether there is a negative relationship between political influences and earnings quality; to judge whether politically influenced firms report poorer earnings quality as compared to non-politically influenced firms.

2) To examine whether politically connected ruling party firms are reporting poor earnings quality compared to politically connected opposition party firms.

3) To investigate whether politically influenced firms substitute real earnings management for accruals earnings management.

1.5 Significance

The impact of political influence on earnings quality remains an area of interest to policy makers, accounting practitioners, auditors, and academic researchers. Though, there are a number of studies that have investigated the impact of political influence on earnings quality, recent studies such as Chi, Liao, and Chen (2016); Al-dhamari and Ismail (2015); Zeng, Li, and Hong (2012) have recommended that political influences and earnings quality need to be investigated in more detail and critically. Hence, this study provides a useful contribution to the existing literature as it has examined the relationship between political influence and earnings quality using multiple aspects and attributes of both variables.

First, this study contributes to agency theory by using political aspects of agency theory. Agency theory explains the basis of conflict that can occur between the agent (managers) and principal (shareholders). The conflict between the agents and principals occur when the act of agents do not meet the interests of the principals and thus create agency conflict. Previous studies show that the presence of politically influenced people in a firm creates agency conflict. However, prior studies argue on agency theory by using only one aspect of political influences i.e. the presence of politicians or close relatives of politicians in a firm. While current study contributes to agency theory by adding two more aspects of political influences (i.e. the presence of civil/military bureaucrats in a firm and a firm significantly owned by government). In addition, our findings contribute to the political economy theory, which argue that a powerful individual (through any aspect of political influences) maintain their self interest

(through targeted information disclosures) to the detriment of those individuals without power (Deegan, 2006).

Secondly, most of the previous studies have used data from multiple countries, while current study used only Pakistani firms' data, which overcomes some criticisms of multiple-countries data. Pakistan is famous for its doubtful relationship between politics and businesses (Saeed, Belghitar, and Clark, 2015; Khwaja and Mian, 2005). Over the last 25 years, three elected governments were dissolved on allegations of corruption and political abuse of power (Cheema, Munir, and Su, 2016). Due to the fact of the weak government institutions and regulatory bodies, the Pakistani business environment looks particularly weak to political influences (Khwaja and Mian, 2005). Pakistan has many politically influenced listed firms; however, there are no restrictions to such political influences (Saeed, Belghitar, and Clark, 2015). Such features of the Pakistani economy provided an interesting platform to examine the effect of political influences on firms' earnings quality. Therefore, this study suggests policy makers and regulators of Pakistan in particular and of other developing economies in general with similar socioeconomic conditions and comparable regulatory mechanism, in order to improve the quality of earnings in politically influenced firms.

Further, this study contributes and extends previous literature in several ways, by selecting Pakistani firms' data. Pakistan lies in the developing economies, which provides diversity in the politically influenced firm's data. Prior studies have used political influenced firm in a limited sense, where firm is assumed to be a politically

influenced if it is affiliated with a single powerful politician (i.e. Dr. Mahathir and Dr. Anwar Ibrahim in Malaysia and Suharto in Indonesia). Unlike in Pakistan, there is a high presence of politicians and their closed relatives in firms. In fact, political system of Pakistan is controlled by influential families and business conglomerate (Cheema, Munir, and Su, 2016; Saeed, Belghitar, and Clark, 2015). Moreover, a political influence varies with the political strength, which provides useful variation in terms of the type of political influences that is used to examine the phenomenon. In addition, this study contributes to the existing literature of political influences by including civil/military bureaucrats as another aspect of political influences. This is because; Pakistan has directly been ruled by military and bureaucrats for several years, which make these bureaucrats equally influential as politicians (Cheema, Munir, and Su, 2016). In addition to civil/military bureaucrats, current study enrich the existing literature of political influences by including significant government owned firm as another aspect of politically influenced firm, because government will place their representatives on board and management to protect government's political interest and concurrently government also act as a shareholder.

Thirdly, this study examined the relationship between political influences and earnings quality using three aspects of political influences and three attributes of earnings quality. In addition, this study also investigated the difference in effect between ruling/opposition party political connections and direct/indirect political connections on earnings quality. Further, it empirically examines whether politically influenced firms substitute between earnings management strategies, which shall also be a

methodological contribution to this domain. Therefore, this study provides more insight and detail investigation on the relationship between political influences and earnings quality, by testing almost all possible aspects of political influences (in Pakistani context) and earnings quality (using both accruals and real earnings management attributes of earnings quality).

Fourth, the current study expands the literature by showing that politically connected firms related to opposition party are reporting poor quality of earnings compared to political connections related to ruling party, because connected firms related to opposition party are more involved in real earnings management. Notably, these findings are one of the main contributions of the current study to the body of literature of political influences and earnings quality. While previous studies have suggested that the politically connected firms related to ruling party are more involved in accruals earnings management (Chaney, Faccio, and Parsley, 2011). The current study findings are contrary to the findings of Chaney, Faccio, and Parsley (2011). This is because; Chaney, Faccio, and Parsley (2011) only employed accruals attributes of earnings quality in their study. However, this study has employed both accruals and real earnings management attributes of earnings quality.

After the implementation of Sarbanes-Oxley Act (SOX), firms shift their manipulation activities from accruals earnings management strategy to real earnings management strategy (Kothari, Mizik, and Roychowdhury, 2012; Cohen and Zarowin, 2010; Cohen, Dey, and Lys, 2008), particularly in politically influenced firms (Chi, Liao, and Chen,

2016; Braam, Nandy, Weitzel, and Lodh, 2015), because real earnings management activities are not easily detectable (Zang, 2011; Roychowdhury, 2006; Gunny, 2005). These shifts of earnings management strategies were noticed in developed economies, where institutions and regulatory bodies are strong. However, the current study expands literature by showing that politically influenced firms manipulate earnings through both accruals and real earnings management measures in a less developed country (i.e. Pakistan), where regulatory bodies are weak.

Fifth, this study extends literature by showing that the presence of politically influenced people in a firm creates agency problem, which resulted in reporting lower earnings quality. Hence, to reduce the impact of agency problem, strong regulatory bodies and enlightened shareholders are needed. The results of the current study will enable shareholders to evaluate the negative effects of political influences on reporting earnings quality. Further, other stakeholders can also use the findings of the current study to identify which factors should be taken into consideration when evaluating a firms' earnings quality, and thus corporate political influences should be taken into consideration in the valuation process. The findings of the current study contributed to in setting up the foundation of agency theory that explains the relationship between political influences and earnings quality in Pakistan and worldwide. Thus, the agency cost in political influences and earnings quality literature could extend to other developing and under-developing economies in the future.

1.6 Scope of the Study

The scope of this study is politically influenced listed firms in Pakistan. There are many reasons for selecting Pakistan data in this research. First, Pakistan's business and economy is very much influenced by politicians (Cheema, Munir, and Su, 2016; Khwaja and Mian, 2005). Politically influenced firms offer a suitable condition to examine the quality of earnings in this environment. Second, the political and business culture in Pakistan is unique in nature. Finally, focusing on one country will overcome some of the constraints of cross-country studies, such as possible difficulties in data collection, analysis and interpretation that arise as a result of differences in cultural and legal system and like.

The study covers the seven-year period from 2008-2014. This period includes one lagged year and one lead year data, because the accruals quality models and real earnings management models adopted in the current study required one lagged year and one lead year data. Data were collected from the State Bank of Pakistan (SBP) and annual reports of 129 listed firms. Annual reports used for the study were retrieved from the website of firms. The analyses of this study focus on political influences and earnings quality, which cover one tenure of the elected government between 2009 and 2013.

1.7 Organization of the Study

The content of this research is divided into six chapters. First chapter highlights the various important contents that are relevant to this study. Specifically, this chapter sheds

a light on the background of the study, which includes discussing earnings quality and its related scandals in the world and particularly in Pakistan. It also includes political influences and its impact on earnings quality. This chapter also explains the problem statement; it reports research questions and research objectives of the study; justifies significance of the study and discusses scope of the study.

The next chapter investigates the results of previous studies that are related to earnings quality and political influences. It consists of two main sections namely; earnings quality definitions and its measurements and political influences, and its impact on earnings quality. Chapter three explains methodology of the study. In addition, it also discusses underpinning theory i.e. agency theory and a theoretical framework; it discusses the hypotheses developed for this study followed by justification of variables, models specification, sampling and methods of data collection and finally methods of analysis.

Chapter Four discusses descriptive statistics, diagnostic tests, reporting of main results followed by sensitivity analysis. Chapter Five covers discussion of the results. The last chapter; Chapter Six, concludes the study by presenting contributions of the study, limitations of the study followed by future research, suggestion and recommendations.

CHAPTER TWO

LITERATURE REVIEW

2.1 Earnings Quality Definitions

Earnings quality is contextual and it means different things to different earnings information users (Dechow and Schrand, 2004). For example, standard setters or regulators view earnings to be of high quality when it is in accordance with Accounting Standards. In contrast, when earnings are easily convertible into cash then it is viewed as high quality from creditors' perspective. Researchers have considered earnings quality in different ways (Kamarudin and Ismail, 2014). For example, Abdelghany (2005); Schipper and Vincent (2003) define earnings quality from the decision usefulness concept. The decision usefulness is the only vital attribute of high earnings quality, because it is empirically good and captures the intent of standard setters (Schipper and Vincent, 2003).

Dechow and Schrand (2004) describe earnings quality wider than decision useful concept, having three categories: first high earnings quality reflect firms' current performance; second, high earnings quality should be a good indicator of future operating performance; and last, it is a useful measure for assessing firm value. In short, high earnings quality accurately annuitizes the real value of the firm. Similarly, Dechow, Ge, and Schrand (2010) in their study define earnings to be of higher quality when it gives more information about future operating performance of a firm. Similarly, some researchers found persistence earnings as important measure of earnings quality.

For instance, Comiskey and Mulford (2000) define high earnings quality as the ability to generate sustainable earnings while Penman and Zhang (2002) classify sustainable future earnings as high quality. It is argued that earnings which are closer to cash flow and contain comparatively small amount of accruals, are considered to be of higher quality (Visvanathan, 2006).

It is argued that earnings which timely recognize losses are considered to be of higher quality of earnings (Basu, 1997). Some researchers such as Ashbaugh, Collins, and LaFond (2006) explain high earnings quality when earnings include timeliness and value relevance. Earnings quality problem arises when firm's earnings lack transparency and include unusual items (Bhattacharya, Daouk, and Welker, 2003).

In addition, Barth, Landsman and Lang (2008) in their study state that earnings which involve less earnings management, timely recognizes losses and thus earnings is considered to be of high value relevance. Similarly, Guay, Kothari, and Watts (1996) argue that managerial opportunism decreases earnings quality and information accuracy. In contrast, Dechow and Schrand (2004) state that some firms will have low earnings quality because of the nature of their business, even without earnings manipulation. This will include firms working in unstable environments as well as high-growth firms. Consequently, both types of firms due to their nature of business and opportunistic management can find their earnings quality affected. In this regard, some authors opine that earnings information consists of errors made by the accounting system and fundamental earnings process (e.g., Dechow, Ge, and Schrand, 2010).

Similarly, Francis and Ke (2006) reveal that earnings quality issue arises from both business environment, and financial reporting processes, such as governance activities, reporting standards and managerial judgment.

In addition, the conceptual Framework of Financial Accounting Standard Board (FASB) gives a general guideline for high earnings quality (Schipper and Vincent, 2003). The main purpose of published accounts or financial reporting is decision usefulness, and thus financial statements which are useful for decision making are considered as high quality (Dechow and Schrand, 2004). Two characteristics behind the financial reporting purpose are representational faithfulness and relevance. Schipper and Vincent (2003) stated that the information is faithfully represented if it is free from error, complete and relevant, and it is said to be relevance if it has predictive or confirmatory value.

2.2 Measurements of Earnings Quality

As discuss above, earnings quality is a multifaceted concept and its measurement is also multifaceted. The current study measures earnings quality through multiple measurements such as accruals earnings management, real earnings management, earnings smoothing, and earnings aggressiveness. Generally, high earnings quality has a high level of persistency, less volatility and total accruals, have lower level of accruals and real earnings management. The following subsections discuss each of the measurement in detail.

2.2.1 Earnings Management

Earnings management is the process of getting desirable earnings through manipulations, within the limitations of generally accepted accounting practice (Davidson, Stickney and Weil, 1985). Similarly, Healy and Wahlen (1999) define earnings management as "intervention in the financial reporting process, with the intention to get some personal or private gain". Managers have the discretions to transfer current income to future periods without the violation of general accepted accounting principles (Dechow and Schrand, 2004), and accounting standards give discretions to managers in preparing financial reports (Kamarudin and Ismail, 2014).

Prior research provides evidence that earnings management exists due to the main functions and roles played by financial reporting. For instance, Bauwhede (2001) claims that some managers' get involved in earnings management activities due to their need for external financing, board quality, audit quality and taxes. Healy and Wahlen (1999) state that firms manage earnings to affect stock prices. Prior to seasoned equity offerings (SEO) firms manage earnings to increase share prices (Dechow and Schrand, 2004). The study also reveals that earnings management mainly occurs after an increasing performance and period of high economic growth in booming economies. Whereas, Burgstahler and Dichev (1997) state that management manage earnings to meet benchmark. Similarly, Degeorge, Patel, and Zeckhauser (1999) reveal that at some places a few firms involve in earnings management to improve their financial image by trying to meet the expectation of investors and achieve profit forecast of the analyst.

High earnings quality exists in the absence of earnings management since unmanaged earnings are of higher quality compared to managed earnings (Dechow and Schrand, 2004). Levitt (1998) argues that earnings quality decreases when firm's management is involved more in earnings management.

Melumad and Nissim (2008) also state that earnings management does not necessarily mean fraud. Fraud though is a severe case of earnings management, whereas Levitt (1998) states that earnings management is found to be in the middle of legitimate accounting and absolute fraud. Badertscher (2011) on the other hand, divides earnings management in three categories: first, earnings management that violates accounting principles; second earnings management in the middle of legitimate accounting and violating GAAP, and third, earnings management within the requirement of GAAP.

Badertscher (2011) too states in his study that firms have two ways to manage earnings. First, firms manage earnings through accruals to get the desired level of earnings. This method is known as accruals earnings management (AEM). Second, firms manage earnings through changes in real business transactions, such as decreasing prices to increase sales, reducing discretionary expenses to increase current earnings, and overproducing goods (inventory) to reduce costs of goods sold. Managing earnings through real business transaction is known as real earnings management (Roychowdhury, 2006).

Zang (2011) opines that firms choose earnings management strategy based on its relative cost. It means that real earnings management (REM) is more useful compared to accruals earnings management (AEM) if the cost of using AEM relative to REM is higher and vice versa. The cost of manipulating earnings depends on the limitations that are applicable on using AEM and REM.

Cohen, Dey, and Lys (2008) also show that after the implementation of Sarbanes Oxley Act (SOX), the level of real earnings manipulation has increased, while accruals based earnings manipulation has decreased. In contrast, throughout seasoned equity offering (SEO) firms use both earnings management strategies (Cohen and Zarowin, 2010). The study further reveals that the SEO firms' inclination to use real earnings management activities is positively related to the costs of accruals earnings management in these firms.

Furthermore, Fields (2001) states that examining only one earnings management proxy at a time underestimates earnings management activities in a firm. Particularly, if managers employ both earnings management strategies as substitutes for each other, then examining only one strategy in isolation underestimates earnings management activities. Similarly, Braam, Nandy, Weitzel, and Lodh (2015) state that taking only accrual-based measure underestimates the earnings management activities. Therefore, this research is motivated to use both accruals and real earnings management as a measure of earnings quality.

2.2.1.1 Real Earnings Management

Firms manage their earnings to obtain the desired level of earnings, and managing earnings through real business activities is known as real earnings management (Roychowdhury, 2006). The Roychowdhury defines real earnings management as "deviation from normal business practices, which is motivated by managers' desire to mislead some stakeholders into believing that certain financial objectives have been met in the normal course of operations". These deviations enable managers to meet financial reporting goals, even though they do not contribute to firm's economic value. Certain real earnings management practices, such as price discounts, overproduction of goods and reduction of discretionary expenditures are probably favorable measures in certain economic situations. However, managers are involved in real earnings management, if they are engaged more extensively in these activities with the objective of beating/meeting an earnings target, (Roychowdhury, 2006).

Graham, Harvey, and Rajgopal (2005) find in their survey that managers are willing to manage real earnings to meet earnings targets such as analyst forecasts, zero earnings and previous periods' earnings, although real earnings management potentially reduces firm value. Real earnings management adversely affects firms' value because real operating measures taken in the current period to increase earnings can have an adverse effect on future periods' cash flows. For instance, to meet short-term earnings target firms offer price discounts to increase sales volumes which can lead customers to expect such discounts in future periods as well. In other words, it means lower profit margins on future sales.

Despite the costs linked to real earnings management (REM) and also because it imposes greater long-term costs on the firm value, managers are unlikely to rely only on accrual-based earnings management to manage earnings. In respect of loss linked to REM, Graham, Harvey, and Rajgopal (2005) state that fifty percent of the CFOs in their survey say that they would accept small losses to meet current earnings targets by postponing new projects, while eighty percent of the CFOs say that, they would decrease expenditure on advertising, maintenance and R&D to meet target earnings. Roychowdhury (2006) on the other hand, give evidence that managers avoid reporting annual losses by decreasing selling, general and administration expenses, overproducing inventory goods to decrease cost of goods sold (COGS), and decreasing research and development costs.

Moreover, firms have poorer performance in the following three years when they beat analyst forecasts by using both earnings management strategies compared to firms that miss analyst forecasts without earnings management (Bhojraj, 2009). In contrast, firms have better performance in the following three years when they meet target earnings through real earnings management compared to firms that do not involve in real earnings management (Gunny, 2010).

Furthermore, managers are willing to manipulate earnings through real earnings management (REM) compared to accruals earnings management (AEM), since relying only on AEM involves a risk and REM is not likely to draw regulators or auditors

scrutiny (Braam, Nandy, Weitzel, and Lodh, 2015; Zang, 2011; Bruns and Merchant, 1990). Prior studies such as Roychowdhury (2006); Gunny (2005) have identified various methods of REM. These methods are further divided into two: manipulations in operating and investing activities, and manipulations through financing activities (Cohen and Zarowin; Xu, Taylor, and Dugan, 2007).

Firms manipulate operating activities by altering the discretionary expenditures, such as selling, general and administrative expenditures (SG&A) and research and development expenditures (R&D). Under international financial reporting standards (IFRS), research and advertising costs are expended in the period in which they are incurred. Therefore, by reducing any of these costs will overstate reported income. Developments costs are revenue expenditure rather than capital expenditure which may have to be postponed due to uncertainty issues related to the developing product or service (IASB 1998, IAS No. 38, para. 57). Hence, postponing development projects can increase earnings as well.

In respect of cost of research and development (R&D), Baber, Fairfield, and Haggard (1991) give evidence that managers reduce R&D, because spending on R&D might risk the ability to report positive earnings in the current period. Similarly, Dechow and Sloan (1991) reveal that CEOs spend less on R&D in their final years in office. Moreover, Bens, Nagar, and Wong (2002) find that managers cut capital expenditure and research and development cost when faced with earnings per share dilution due to stock option exercises. In contrast, however, Holthausen, Larcker, and Sloan (1995) find that

managers do not cut research and development expenditure to increase managerial bonuses.

Moreover, in manufacturing firms, REM through over-production of goods become a better choice because operating activities are then manipulated through overproduction of goods with the objective to decrease cost of goods sold (Zang, 2011; Roychowdhury, 2006). Costs of goods sold per product decreases because of overproduction of goods, since the fixed overhead costs will then be spread over a larger number of products. In addition, the Roychowdhury states that firms that involve in (REM) exhibit at least one or more of the following characteristics: abnormally low discretionary expenses and abnormally high production costs. To capture REM through discretionary expenses, Braam, Nandy, Weitzel, and Lodh (2015); Cohen and Zarowin (2010); Roychowdhury (2006) estimate the following equation:

$$\frac{DISX_t}{A_{t-1}} = \beta_0 + \beta_1\left(\frac{1}{A_{t-1}}\right) + \beta_2\left(\frac{S_{t-1}}{A_{t-1}}\right) + \varepsilon_t$$

Where: $DISX_t$ is the discretionary expense at year t, which is computed as the sum of selling, general, and administrative expenses (SG&A) and research and development (R&D) expenses; A_{t-1} is the total assets in year t-1; S_{t-1} is the net sales in year t-1.

Roychowdhury (2006) estimate the normal level of production costs using the following equation:

$$\frac{PROD_t}{A_{t-1}} = \beta_0 + \beta_1(\frac{1}{A_{t-1}}) + \beta_2(\frac{S_t}{A_{t-1}}) + \beta_3(\frac{\Delta S_t}{A_{t-1}}) + \beta_4(\frac{\Delta S_{t-1}}{A_{t-1}}) + \varepsilon_t$$

Where $PROD_t$ is the sum of the cost of goods sold (COGS) in year t and the change in inventory from t-1 to t; A_{t-1} is the total assets in year t-1; S_t is the net sales in year t; and ΔS_t is the change in net sales from year t-1 to t. The abnormal level of production costs RM_{PROD} is measured as the estimated residual from the above equation. The higher the residual, the larger is the amount of inventory overproduction, and the greater is the increase in reported earnings through reducing the COGS.

Firms manage earnings through deviation from real business activities in order to achieve target earnings. However, due to the different operating environment, the consequences of deviating from real business activities differ across industries. For instance, in competitive industry, it is comparatively more costly to deviate from normal business activities as it would reduce the competitive advantage of a firm in industry in comparison with less competitive industry. This is because; firm operating in a less competitive industry can deviate from normal business activities as it faces less competition. Therefore, the use of real earnings management constrains with the level of competition within an industry.

Furthermore, achieving earnings target through real earnings management may result in higher levels of taxable income. Consequently, higher taxable income would constrain

firms to use real earnings management, because it may lead to higher marginal tax rates. Moreover, real earnings management through over-production may increase other costs of firm such as storage and impairment costs. Therefore, real earnings management through over-productions constrains with the availability of storage.

2.2.1.2 Accrual-Based Earnings Management

Earnings consist of accruals and cash flows; accruals are discretionary and based on estimates while cash flows are considered more consistent than accruals (Dechow, 1994). Earnings are mostly manipulated through accruals (Dechow, 2011) and numerous measures view that high accruals reduce earnings quality (Francis and Ke, 2006). As accruals give discretion to use judgments, it provides opportunity for earnings management (Dechow and Schrand, 2004).

In addition, managers use their discretions in reporting process to manipulate earnings, which is known as accruals earnings management (Healy and Wahlen, 1999). However, discretions could be controlled by auditors' scrutiny (Becker, 1998). Moreover, the use of discretions in reporting process is reduced substantially after regulator's scrutiny and adoption of Sarbanes Oxley Act (SOX) (Cohen, Dey, and Lys, 2008). Since the purpose of SOX is to protect shareholders, it implies that investor protection restrict firms from accruals earnings management. Similarly, Leuz, Nanda, and Wysocki (2003) confirm that investor or shareholders protection is negatively related to accruals earnings management.

However, this does not mean that accruals do not prove a useful decision. For example, Sloan (1996) in his study finds that earnings are more reliable compared to cash flows, whereas, Penman and Sougiannis (1998) state that earnings produce smaller forecast errors. Dechow and Schrand (2004) on the other hand reveal that accruals enhance decision usefulness by reducing irrelevant variations in cash flows. Moreover, a firm with high total accruals is not necessarily a sign of poor earnings quality (Dechow and Schrand, 2004). The authors state that some firms could have low predictability and accruals quality, because of its business nature; such as firms with a large amount of intangible assets and high growth.

Levitt (1998) states that earnings quality is on the decline while accruals earnings management is on rise. The current study is using accruals quality model to detect accruals earnings management. The next section discusses this aspect in detail.

2.2.1.3 Accruals Quality

Dechow and Dichev (2002) first proposed the model or concept of accruals quality (AQ) as a measure of earnings quality. Regardless of the intention, Dechow and Dichev do not differentiate between intentional and un-intentional errors because all errors indicate poor accruals quality. The authors measure accruals quality by matching operating cash flows and working capital accruals; thus, a poor match indicates poor accruals quality. In particular, this model regress a change in working capital on the cash flow of previous last year, present year, and next year.

In addition, Dechow-Dichev (DD) Model was also further modified and enhanced by McNichols (2002) after including additional explanatory variables i.e. revenue, and Property, Plant, and Equipment (PPandE). Kent, Routledge, and Stewart (2010) find that the DD model and modified DD model perform equally well whereas Francis, LaFond, Olsson, and Schipper (2005) find that the modified concept or model has better explanatory power.

$$TCA_{j,t} = \partial_0 + \partial_1 CFO_{j,t-1} + \partial_2 CFO_{j,t} + \partial_3 CFO_{j,t+1} + \partial_4 \Delta REV_{j,t} + \partial_5 PPE_{j,t} + \varepsilon_{j,t}$$

Modified Dichew-Dichev Model

Where, $TCA_{j,t}$ is total current accrual of firm j in year t; CFO is cash flows from operations of firm j in year t; ΔRev is revenue of firm j in year t; and PPE is gross property, plant, and equipment of firm j in year t. All the variables are scaled by lagged total assets. The variance of ε is an inverse measure of accruals quality (AQ).

Instead of total accruals, DD and modified DD models concentrate only on current accruals. Researchers criticize both models for concentrating only on short-term working capital (Dechow, Ge, and Schrand, 2010; Barth, Landsman, and Lang, 2008). Barth, Landsman, and Lang (2008), for instance, also criticized the model for not considering the perception of analysts and investors, and it was observed that instead of total accruals it concentrates only on current accruals.

2.3 The difference between Accruals Earnings Management and Real Earnings Management

Accrual earnings management and real earnings management have many differences. For example, when the firms manipulate the earnings, the accrual-based earnings manipulation comes under the scrutiny of auditors and regulators, while real earnings management does not come under the jurisdiction of auditors and regulators (Braam, Nandy, Weitzel, and Lodh, 2015). Secondly, variations in current and future cash flows also vary for accruals and real earnings management (Braam, Nandy, Weitzel, and Lodh, 2015; Cohen, Dey, and Lys, 2008; Roychowdhury, 2006). In addition, firms' managers can manipulate real earnings throughout the year as real earnings management provides more flexibility to managers (Gunny, 2010). In contrast, accruals-based earnings management represents accounting choices that occur before the issuance of the financial statements, which is at the end of the fiscal year (Dechow and Skinner, 2000).

Further, real earnings management provides flexibility to managers, which gives opportunities to deviate from normal business activities, such as reduction of cost of goods sold through over-production of goods, sales prices to increase sales volume, selling, general, and administrative (SGand A) expenses, research and development (RandD) expenditure (Roychowdhury, 2006; Gunny, 2005). Contrary to real earnings management, accrual-based earnings management reverses over time and has no direct impact on operating cash flows (Healy and Wahlen, 1999).

Moreover, when regulatory bodies and institutions show strength, managers prefer to employ real earnings management strategy, instead of accrual earnings management strategy in order to avoid detection by the regulators (Braam, Nandy, Weitzel, and Lodh, 2015). Some authors argue that after the implementation of Sarbanes-Oxley Act 2002 (SOX), firms have switched from accruals earnings management to real earnings management (Braam, Nandy, Weitzel, and Lodh, 2015; Cohen, Dey, and Lys, 2008), because SOX impose restrictions on accruals earnings management (Cohen, Dey, and Lys, 2008), and real earnings manipulation are not easily detectable (Braam, Nandy, Weitzel, and Lodh, 2015; Zang, 2011).

In addition, Braam, Nandy, Weitzel, and Lodh (2015) provide evidence that politically connected firms employ real earnings management to avoid detection by the regulators and media. The authors further argue that politically connected firms substitute accruals earnings management for real earnings management when there is a high level of public monitoring. Consistent with Braam, Nandy, Weitzel, and Lodh (2015), Chi, Liao, and Chen (2016) document that firms with politically connected CEOs are engaged intensively in high level of real earnings management and low level of accrual earnings management to avoid the scrutiny. Similar evidence is presented by Cohen and Zarowin (2010), who argue that to avoid the detection and scrutiny by the regulators; firms' tend to substitute between both earnings management strategies. Although real earnings manipulation activities are less detectable and less risky (Zang, 2011; Cohen and Zarowin, 2010), some authors opine that the consequences of real earnings management

activities have severe long term effects for future performance, and are even greater than the accrual earnings management (Kothari, Mizik, and Roychowdhury, 2012).

2.4 Earnings Management Motivations

2.4.1 Earnings Benchmarks

Earnings benchmark is considered to be one of the most important indicators to evaluate firms' performance by many users of the accounting information. Firms' could achieve earnings benchmarks through normal business activities; however, managers manipulate earnings when forecast earnings fall short of the desired earnings. This shortfall between actual and desired earnings motivates managers to indulge in income increasing earnings management to avoid reporting earnings below the benchmarks (Al-dhamari and Ismail, 2015; Zang, 2011; Burgstahler and Dichev, 1997). Consistent with the findings of Burgstahler and Dichev (1997), who argue that firms get involved in real earnings manipulation activities to meet earnings benchmarks i.e. meeting analysts' forecasts and avoiding report of losses (Roychowdhury, 2006). Other studies investigate the negative relationship between the earnings benchmarks and research and development (RandD) expenditure. The authors opine that firms reduce RandD expenses to meet earnings benchmarks (Osma and Young, 2009).

2.4.2 Timing Equity Offerings

Firms issue seasoned equity offering (SEOs) and initial public offering (IPO) to raise capital, increase the number of its shareholders, and expand its operational capabilities in the financial markets. Prior studies document that firms manage earnings to enhance reported earnings around the SEOs and IPOs (e.g., Kothari, Mizik, and Roychowdhury,

2012; Cohen and Zarowin, 2010; Rangan, 1998; Teoh, Welch, and Wong, 1998). Other studies document that firms which get involved in earnings manipulation during equity offering, experience reduction in post equity offering earnings. For example, Teoh, Welch, and Wong (1998) argue that IPO firms engage in income increasing accruals earnings management during the equity offering experience a decline in performance after the IPO for three years.

Consistent with the findings of Teoh, Welch, and Wong (1998), Kim and Park (2005) exemplify that SEO firms that involve in high level income increasing accrual earnings management during the equity offering, later experience a decline in performance. Similarly, some authors opine that IPO firms with high levels of accrual-based manipulation during the first year after the IPO experience a worse stock performance for three years after the IPO (DuCharme, Malatesta, and Sefcik, 2004; Roosenboom, Goot, and Mertens, 2003).

Prior studies have focused on accruals earnings management strategy only; however, other studies such as Kothari, Mizik, and Roychowdhury (2012); Cohen and Zarowin (2010) have examined both accruals and real earnings management strategies. The authors argue that the equity offering firms employ both earnings management strategies and therefore comparatively real earnings manipulation activities have more negative consequences than accruals earnings manipulation for subsequent performance.

2.4.3 Executive Compensation

Prior studies document about the compensation of Chief Executives Officers (CEOs), stating that performance-based compensation motivates managers to get involved in income increasing earnings management (Sun, 2012; Cheng and Warfield, 2005), which negatively affect shareholders' wealth (Kothari, Mizik, and Roychowdhury, 2012; Fan, Wong, and Zhang, 2007). CEOs engage in income increasing earnings management to meet performance-based compensation through real earnings management (e.g. Cao and Laksmana, 2010; Cheng, 2004; Dechow and Sloan, 1991), and accrual-based earnings management (e.g. Laux and Laux, 2009; Cheng and Warfield, 2005).

Moreover, some authors opine that the Chief Financial Officers (CFOs) are comparatively more involved in reporting earnings processes than the CEOs and, thus, CFO equity incentives are positively related to beating analysts' forecasts and accrual earnings management, with even greater impact than CEO equity incentives (Jiang, Petroni, and Wang, 2010). On the contrary, Feng, Ge, Luo, and Shevlin (2011) argue that the CFOs are likely to get involved in earnings management as a response to a pressure from their powerful CEOs.

2.4.4 Debt Contracts

Prior studies exemplify that firms get involved in earnings management activities to avoid violations of debt contracts; and that firms are more likely to do so when their ability to renegotiate the technical contract violations is restricted (e.g., Franz, HassabElnaby, and Lobo, 2014; Kim, Lei, and Pevzner, 2011). However, Franz,

HassabElnaby, and Lobo, (2014) argue that firms with a stronger incentive to avoid debt contract violation switched from using more accruals earnings management before the Sarbanes–Oxley Act to using more real earnings management and more total earnings management afterwards. The authors further argue that firms with poor credit rating are more engaged in earnings management. In a similar study, Kim, Lei, and Pevzner (2011) find that firms get involved in earnings management activities to avoid violations of debt contracts; and that firms are more likely to do so when they do not meet analyst forecasts and exhibit poor credit ratings. The authors further argue that the firms with more rigid managers to re-negotiate a debt contract engage more in real earnings management activities in order to avoid contract violations.

Other studies provide evidence that firms involve in income increasing/decreasing earnings management to avoid debt contracts violations (e.g., Jaggi and Picheng, 2002). Sweeny (1994) conducted a study on debt contracts violation who find out that firms employ income-increasing earnings management to decrease the cost imposed by lenders. These findings are consistent with those of DeFond and Jiambalvo (1994) who investigate the relationship between accruals earnings management and debt contracts violations. The authors examine a high total accrual in the year prior to the debt contract violation.

On the contrary, Jaggi and Picheng (2002) find that the debt contract violating firms use income-decreasing accruals earnings management when their waiver requests for violations are denied. However, when their waiver requests for debt covenant violations

are accepted, financial distressed firms use income-increasing accruals earnings management. Similarly, Bartov (1993) provide evidence that firms increase reported earnings through timing the sales of their long-term assets to avoid contract violations and smooth reported earnings.

2.4.5 Political Cost

Prior studies have also observed that firms manipulate earnings to avoid political cost. For instance, Key (1997) provide evidence that a few firms indulge in income decreasing earnings management only to avoid detection by the regulators, and reduce the chances of imposing new regulations if their firms report high profits. Similarly, Han and Wang (1998) indicate that firms that engage in income-decreasing accruals earnings management to avoid political cost, are likely to report high profits. This is the reason, some authors argue that firms manipulate earnings to cover and hide their political gains, which they receive through their political connections (Chaney, Faccio, and Parsley, 2011). Other authors opine that politically connected firms substitute between earnings management strategies to avoid detection and scrutiny by regulators and media (Braam, Nandy, Weitzel, and Lodh, 2015).

This section discusses several motivating factors which encourage managers to get engage in earnings management activities. It is observed from previous literature that firms get involved in income increasing/decreasing earnings management activities in order to achieve their objectives. Firms inflate earnings through both accruals and real earnings management in order to achieve earnings benchmarks, avoid violations of debt

contracts, before equity offering, executive compensations. On the contrary, firms' managers get involved in income decreasing earnings management activities in order to report poor organizational performance, and thus report less taxable income. Further, managers are engaged in income decreasing earnings management activities to cover the political gains which they obtain through dubious legality. Going through the literature notably, it is argued that earnings management activities are contextual and it varies with the objectives of firms. Therefore, it is suggested that firms get engaged in both income increasing/decreasing earnings management activities and it varies with firms' objectives.

2.5 Earnings aggressiveness

Earnings aggressiveness is the propensity to speed the realization of gains and delay the realization of losses, which would eventually result in more positive or high accruals (Bhattacharya, Daouk, and Welker, 2003). The author adopts the magnitude of accruals as a measure of earnings quality. He states that the opportunistic overstatement of earnings increases the level of total accruals. Earnings aggressiveness also reduces earnings quality because it increases total accruals, and high accruals represent less persistent earnings (Dechow, Ge, and Schrand, 2010). These researches further argue that firms usually present high total accruals when they get involved in earnings manipulations activities. Similarly, Leuz, Nanda, and Wysocki (2003) use the magnitude of accruals as a measure for earnings management. Whereas, Bhattacharya, Daouk, and Welker (2003) measure earnings aggressiveness as the magnitude of accruals:

$$ACC_{kt} = (\Delta CA_{kt} - \Delta CL_{kt} - \Delta CASH_{kt} + \Delta STD_{kt} - DEP_{kt} + \Delta TP_{kt}) / TA_{kt-1}$$

Earnings aggressiveness

Where; ACC_{kt} are the total accruals of firm k in year t; ΔCA_{kt} is change in current assets of firm k in year t; ΔCL_{kt} is the change in current liabilities of firm k in year t; $\Delta CASH_{kt}$ is the change in cash of firm k in year t; ΔSTD_{kt} is the change in long-term debt included in total current liabilities for firm k in year t; DEP_{kt} is the amortization and depreciation expenses of firm k in year t; ΔTP_{kt} is the change in tax payables of firm k in year t; TA_{kt-1} is the total assets of firm k in year t-1.

The earnings aggressiveness (EA) model is simplistic and cannot be seen independently; moreover it is less often used as the only proxy of earnings quality (Dechow and Schrand, 2004). Due to their business nature some firms have higher level of accruals (Dechow and Schrand, 2004). Moreover, Dechow, Ge, and Schrand (2010) states that underlying performance of firms is probably different in firms with lower accruals from those with higher accruals; moreover, they opine that this variation in accruals probably stems from sources other than AEM.

2.6 Comparison of Measurements

As discussed above in the review of different measurements and attributes of earnings quality, there is no particular attribute which captures the overall concept of earnings

quality. Instead, attributes should not be seen as substitutes of each other because each attribute exemplify a different concept of earnings quality. For instance, Dechow, Ge, and Schrand (2010) states that some of the measurements are negatively related to each other and therefore they can have reverse implications and requires to carefully choose the particular measurement which is suitable for their research questions. Similarly, Dechow, Richardson, and Tuna (2003) states that discretionary accruals are highly correlated with overall level of accruals. Dechow and Dichev (2002), on the other hand, states that the accruals quality is closely related to earnings persistence because accruals are not correlated to cash flows when accruals are of lower quality; thus accruals quality captures the volatility in earnings persistence.

A major contradiction also exists between earnings persistence, earnings predictability and earnings smoothing because persistent and predictable earnings may be the result of opportunistic earnings smoothing (Dechow, Ge, and Schrand, 2010). However, artificially smooth income increases the predictability and persistence but deteriorates the correlation between earnings and cash flow (Melumad and Nissim, 2009). The fact that earnings quality attributes are not substitutes, it often provides an opposite interpretation to each other, and thus gives an opportunity to researchers to evaluate different perspectives of the multifaceted or wide-range earnings quality concept. Therefore, it involves careful selection criteria to select a suitable earnings quality attribute; to make sure they are appropriate to achieve research objectives.

Table 2.1
Overview of Earnings Quality (EQ) Measurements

EQ Model	Citation	Intuition
Roychowdhry Model	Roychowdhry (2006)	High production cost compared to last year, decrease in discretionary expenses indicate real earnings management, which decreases earnings quality.
Modified Dechow-Dichew Model	McNichols (2002)	Working capital to be closely linked to past, current, and future cash flows. High variations in accrual not clarified by cash flows indicate lower earnings quality (EQ).
Earnings Aggressiveness (Magnitude of accruals)	Bhattacharya, Daouk, and Welker (2003)	High level of accruals indicates lower EQ.

2.7 Determinants of Earnings Quality

Prior studies have examined many determinants that affect the quality of earnings (See Figure 2.1). Francis and Ke (2006) divide then into two groups, the fundamental group and the reporting basis group. The first group consists of the operating environment and business model of the firm, while the second group consists of governance activities, auditors, the quality of the standards and management's financial reporting decisions. The fundamental determinants of a firm such as age, size, governance structure, diversification, leverage, growth, and profitability can decrease earnings quality, even without earnings manipulations (Dechow and Schrand, 2004).

It is widely accepted that the diligence of regulators and the quality of accounting standards are vital determinants of earnings quality. For example, Houqe, Zijl, and Dunstan (2012); Kwon, Lim, and Tan (2007); Soderstrom and Sun (2007) mention in their study, that the legal and the tax system, the accounting standards and political systems are drivers of earnings quality. Whereas, Levitt (1998) states that external auditing and improvement of accounting standards increase earnings quality. In a similar study, Ismail, Kamarudin, Zijl, and Dunstan (2013); Barth, Landsman, and Lang (2008) provide evidence that the earnings quality has improved, after the adoption of International Financial Reporting Standards (IFRS) and implementation of International Accounting Standards (IAS). Similarly, Beuselinck, Joos, Khurana, and Meulen (2009) note that after the adoption of International Financial Reporting Standards (IFRS), earnings quality has positively changed. Such findings support the view that earnings quality is positively related to high quality accounting standards.

In contrast, Ewert and Wagenhofer (2005) illustrate that real earnings management cannot be restricted to better accounting standards; however it increases the quality of earnings. Whereas, Ball, Robin and Wu (2003) find that high earnings quality is not guaranteed by high accounting standards. It is other incentives which influence earnings quality.

Moreover, Caramanis and Lennox (2008); Doyle, Ge and McVay (2007) find out that audit efforts and internal governance positively affects earnings quality. Caramanis and Lennox (2008) in their study use data of a few Greek companies and reveal that audit

efforts reduce earnings manipulations and increases earnings quality. Some authors argue that weak internal control negatively affects earnings quality (Doyle, Ge and McVay, 2007).

Prior studies have also found that corporate governance has positive effects on earnings quality (Badolato, Donelson, and Ege, 2014; Salehi, 2013; Chtourou, Bedard, and Courteau, 2001). Badolato, Donelson, and Ege (2014) find that audit committees with high relative status and financial expertise are linked to lower levels of earnings management. Salehi (2013) use the Iranian data to examine that audit committees ensure higher earnings quality. The study further reveals that high earnings quality requires that the board of directors to be taken into account. Similarly, Chtourou, Bedard, and Courteau (2001) opine that large Board of Directors and shareholding by non-executive directors seem to reduce earnings manipulation which increases the earnings quality.

Studies also reveal that financial or capital market forces impact the quality of earnings. Ball and Shivakumar (2005) state that due to high market demand public firms have earnings quality higher than private firms. Whereas, Soderstrom and Sun (2007) argue that earnings quality is influenced by capital market development. In a similar study, Burgstahler, Hail, and Leuz (2006) examine how institutional factors and capital markets pressures affect firms' incentives to report accurate earnings. In addition, Gao and Zhang (2015); Kim, Park andWier (2012) find that socially responsible firms have high earnings quality. Gao and Zhang (2015) reported that socially responsible firms'

earnings are more value relevant and deviate less from their permanent earnings. On the other hand, Kim, Park, and Wier (2012) using American firms' data reveal that socially responsible firms are less involved in accruals and real earnings management, and provide reliable and transparent financial information to investors.

Furthermore, firms' earnings quality is also affected by other factors such as ownership and capital structure (Ben-Nasr, Boubakri, and Cosset, 2015; Soderstrom and Sun, 2007); the accounting methods selected by the firms (Altamuro, Beatty, and Weber, 2005), and firms' performance (Defond and Park, 1997). Ben-Nasr, Boubakri, and Cosset (2015) also find out that foreign ownership is related to higher earnings quality in countries with lower risk of government expropriation and higher government stability. Whereas, Fan and Wong (2002) find that concentrated ownership is linked to lower earnings informativeness. Similarly, Altamuro and Beatty (2010) reveal that corporate governance mechanisms and internal control regulation of the firm also affect the earnings quality. However, Dechow and Schrand (2004) state that high growth companies, firms in volatile business environments and companies with complex transactions or intangible assets, can give earnings numbers that do not indicate future cash flows or truly reflected firm performance.

In addition, previous studies have shown the significant relationship between political influences and earnings quality. For example, Al-dhamari and Ismail (2015); Ben-Nasr, Boubakri, and Cosset (2015); Braam, Nandy, Weitzel, and Lodh (2015); Zeng, Li, and Hong, 2012; Liu, Saidi, and Bazaz (2014); Narayanaswamy (2013); Chaney, Faccio,

and Parsley (2011) quantitatively investigate the relationship between politically influenced firms and earnings quality. In their studies they find that politically influenced firms are more frequently involved in earnings management and earnings smoothing to achieve desirable results, rarely recognize losses on time and there earnings are less predictable. They also reveal that politically influenced firms have significantly higher discretionary accruals and lower accruals quality compared to non-politically influenced firms. Therefore, it is trended that political influences are negatively related to earnings quality.

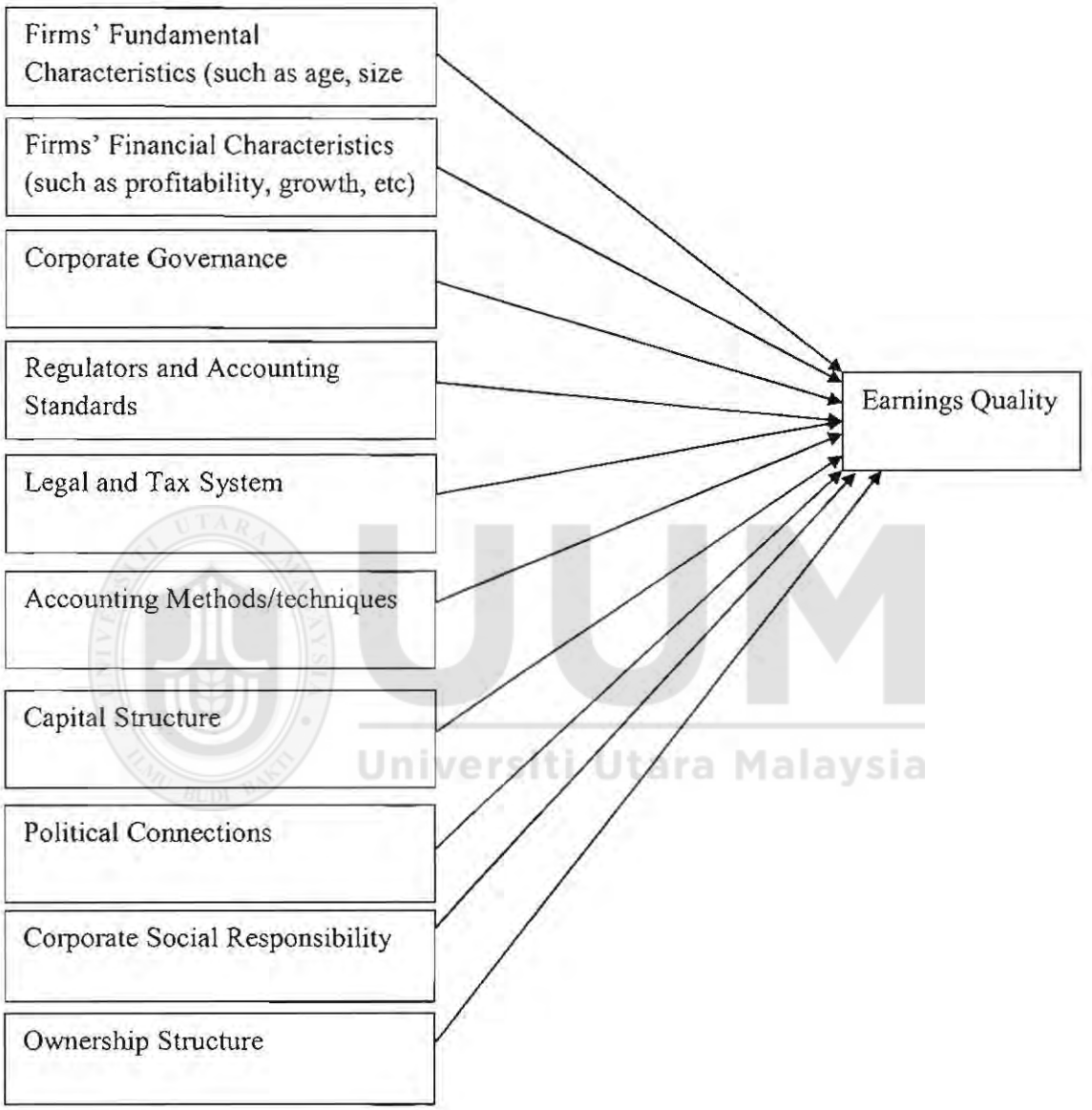

Figure 2.1: *Determinants of Earnings Quality determined by previous studies*
Source: *Author' complied based on previous studies*

2.8 Political influences

Political influence of firms is considered as intangible asset or relational asset, which shows firms' connections with politicians and its influence on firms' decision making (Saeed, Belghitar, and Clark, 2015). In addition to connections with politicians, Cheema, Munir, and Su (2016) also considered firms to be politically influenced if there is a presence of civil/military bureaucrats in a firm. Prior studies have shown that political influences have a broad impact on firms' earnings quality. Political influences are defined as the relationship between a particular firm and a politician(s); it could be either through cronyism (political appointments in firms) or shareholding or political board of directors (Cheema, Munir, and Su, 2016; Saeed, Belghitar, and Clark, 2015; Faccio, 2006; Khwaja and Mian, 2005; Johnson and Mitton, 2003). Moreover, Desai and Olofgard (2011) define political influences as such measures through which the firms with political influences receive favors, which can even contain economic value.

Moreover, prior studies have shown that political influences can be acquired through connections with individuals who have position(s) in the government (Faccio, 2006; Johnson and Mitton, 2003; Fisman, 2001), or through state ownership of firms (Opper and Wong, 2007; Bushman, Piotroski, and Smith 2004), or through the presence of politician(s) or their close relatives on the board of directors (BOD) or in senior management (Cheema, Munir, and Su, 2016; Faccio, 2006), or through the presence of current/former civil/military Bureaucrat(s) on the BOD or in senior management (Cheema, Munir, and Su, 2016; Fan, Wong, and Zhang, 2007). Political influences

through politician(s) and close relatives are difficult to find, because connections with politicians are informal and formal relations are never shared or disclosed.

Prior studies identify political influences as rent-seeking activities where firms use resources in bribing or lobbying to get preferential treatment and privileges from government officials. Khan and Jomo (2000) explain the rent-seeking activities in which firms try to influence the state through bribing, lobbying or through political connections. The benefits from such rent-seeking activities directly depend upon the spending power of a firm.

The impact of political influences on firms' activities has already been recognized around the globe. For instance, Boubakri et al. (2008) state that firms create political influences to increase their chances of success. In fact, political influences give benefits to both parties: the politician(s) reward the firms in form of privileges and policies; which provide support to the politicians, financially and politically; whereas firms use these political influences to enrich themselves (Boubakri, Cosset, and Saffar, 2008). Prior studies have found many bases for the involvement of firms in political relationships; these bases are categorized at firm and industry level.

At the firm level, researchers recognize political influence as an option which aims to enhance the firm's overall value. The firms seek to utilize opportunities in their business while designing their corporate strategies. Though many of these opportunities offer themselves in markets; however, by investing in political connections firms create new

opportunities (Leuz and Oberholzer-Gee, 2003). However, the choice to become a politically influenced firm depends on firms' particular factors i.e. financial resources, size and international diversification (Schuler, 1996).

The large size of groups or firms signifies its possibility to get involved in political activities. Similarly, Hillman (2003) stated that only big firms afford to get political favors because political influences involve huge cost. Diversifications of the firms' have also been linked to political influences, because diversified firms have a wide range of trade activities, and are probably to get involved in political activities (Lenway and Rehbein, 1991). Lastly, prior research has found that huge capital is prerequisite for involvement in costly political activities (Keim and Baysinger, 1988). So, firms with huge capital or financial resources are likely to get involved in political activities compared to firms' lacking such financial resources.

In industry level, the degree of competition within industry has huge effects on the strategy of the firms (Schuler, Rehbein, and Cramer, 2002). Because of intense competition pressure, firms in industries find political influences highly important to get privileged treatment and protection from the government (Jia, Shi, and Wang, 2012). Similarly, Nee, Opper, and Wong (2007) found that political influences give competitive advantage in highly competitive industries and firms have more advantages to create political influences since they get more political benefits. Schuler, Rehbein, and Cramer (2002) on the other hand found that firms in a competitive industry are

more involved in campaign and lobbying compared to those in less competitive industries.

The nature of political influences is different amongst countries. In developed countries, for example, the firms give political donations for campaign, and get involved in lobbying to establish political influences. On the other hand, in under-developed or developing countries, political influences are usually achieved through direct financial dealings between the politician(s), senior managers and owners (Desai and Olofgard, 2011).

In many under-developed or developing countries, governmental restrictions on economic activities are a known reality. Such restrictions provide an opportunity to those firms with strong political influences to get special treatment in terms of policy implementation and resource allocation (Jia, Shi, and Wang, 2012). Therefore, with regard to conduct business efficiently in such an environment, political influences through government officials and politicians facilitate the firms to overcome all the difficulties.

In developing countries firms also establish a political connection through establishing a link with the most influential families or individuals, in order to get easy access for loans (Khwaja and Mian, 2005). Due to the time-consuming activities of financial institutions, firms in under-developing and developing economies face difficulties in getting bank loans because of government regulations. Therefore, political influences

help firms to overcome problems relating to an ill-functioning market in such economies. Firms may have the ability to access leverage because they might have created strong connections with families or individuals that have the ability to control bank-lending policy. On the other hand, banks also expect to get some benefits by giving such loans and leverages (Infante and Piaza, 2010).

Grounded by the previous studies, it is argued that politically influenced obtain more benefits such as easy access to loans on lower interest rates, tax rebates, government contracts, leverage, and get special treatment in terms of government policy implementation. After obtaining all these political benefits through dubious legality, politically influenced firms want to cover and mask these political benefits, and thus get involved in manipulating earnings.

2.8.1 The Politics in Pakistan's Context

Pakistan is a commonwealth country, which is located in the South Asia (Cheema, Munir, and Su, 2016). It is a federal republic comprising a capital territory, named Islamabad, and four provinces, named, Sindh, Punajb, Baluchistan, and Khyber Pakhtunkhwa. With reference to the Constitution of Pakistan (1973), the provincial governments have unicameral provincial assemblies, which are headed by the elected Chief Ministers, while Federal Government has a bicameral parliament which is led by the elected Prime Minister. Pakistan scores low on World Bank governance indicators – regulatory quality (24 percentile), rule of law (21 percentile), voice and accountability

(24 percentile), government effectiveness (23 percentile), political stability (0.95 percentile), and control of corruption (17 percentile).

Since the independence of Pakistan, except for military dictators and elected government backed by dictators, no political government has been able to complete its tenure, because of political instability (Constable, 2001). Elected governments were either toppled by the military dictators or dismissed by the President on charges of corruption, political abuse of power, and mismanagement (Saeed, Belghitar, and Clark, 2015). In 2013, first time in the history of Pakistan, elected government formed as a result of 2008 general elections, completed its five-year tenure without any dictator's backing (Cheema, Munir, and Su, 2016).

The listed firms in Pakistan are governed by the Securities and Exchange Commission of Pakistan (SECP), and firms are required to abide by the Code of Corporate Governance (CCG) of Pakistan, which is an essential part of listing requirements of the Pakistan stock exchange (PSE). Therefore, the PSE, SECP, and CCG Pakistan comprise major regulatory mechanism for listed firms of Pakistan.

The regulatory mechanism is theoretically strong in Pakistan, but has not been implemented practically (Cheema, Munir, and Su, 2016). In addition, conflict of interest laws are weak in Pakistan, which allows civil servants and politicians to get political benefits (Cheema, Munir, and Su, 2016). Further, presence of government owned banks provide opportunity to politically connected firms to default on bank loans (Khwaja and

Mian, 2005). Therefore, weak regulatory bodies, institutes, and legal system, result in poor corporate governance practices in Pakistan.

Moreover, the tax collection authority named, the Federal Board of Revenue (FBR), is always blamed for issuing Statutory Regulatory Orders to facilitate politically influenced people (Cheema, Munir, and Su, 2016). The authors' further claim that the discretionary powers in tax assessment allow corrupt practices in the FBR. In addition to the weakness of FBR, National Accountability Bureau (NAB), which is the authority to curb financial corruption, is always accused of being a politicized authority (Cheema, Munir, and Su, 2016).

2.8.2 Consequences of Political Influences

As discussed earlier, noticeably the main purpose of political influences is to get benefits that are favorable for firms' financial success. Some researchers argue that firms make political connections to receive economic benefits (Braggion and Moore, 2013; Fisman, 2001). In contrast, other authors reveal that politicians may take more resources from firms through operational inefficiencies or bribes, then confer the same back to the firm for personal gains (Frye and Shleifer, 1997; Shleifer and Vishny, 1994). Rationally, firms usually establish and maintain their political influences when the marginal costs of such political influences are less than their own marginal benefits.

Using data from multiple countries, prior studies document that politically influenced firms receive number of benefits, which include government bailouts, the allocation of

governmental contracts, tax evasion, relaxed regulatory, easy access to credit and preferential treatment by state-owned firms (Boubakri, Guedhami, Mishra, and Saffar, 2012; Faccio, 2006). Faccio (2006) claims that political connected firm plays a vital role in world's most countries. For instance, In Thailand, Indonesia, Malaysia, Italy and Russia, more than 10% of listed firms are politically influenced and they account for over 10% of the market wealth. The study also finds that politically influenced firms represent 8% of the worlds' stock market wealth existing in 35 of the 47 countries of the sample. Further, Faccio (2006) also finds out that during a crisis, politically influenced firms have a greater probability to be bailed out by the government compared to similar non-politically influenced firms.

Using multiple-countries data, prior studies examine the impact of political influences on cost of capital, firms' value, organizational performance, and leverage (Boubakri, Guedhami, Mishra, and Saffar, 2012; Faccio and Parsley, 2009; Boubakri, Cossett, and Saffar, 2008; Faccio, 2006). For example, Faccio (2006) using 35 countries data found that the market value of firms with political influence is affected by unexpected electoral outcomes. The study of Faccio (2006) revealed that the announcement of senior management or large shareholders entering into politics significantly increases the value of politically influenced firms. In contrast, Faccio and Parsley (2009) reported an average decline in the value of politically influenced firms by 1.7% in response to 122 sudden deaths of politicians from around the world between 1973 and 2004. These findings show that political influence have significant impact on firms' value (Faccio and Parsley, 2009; Faccio, 2006).

Moreover, some researchers argue that politically connected firms are high leverage and exhibit poor organizational performance (Boubakri, Cosset, and Saffar, 2008). Other researchers documented that politically connected firms enjoy lower cost of capital compared to non-politically connected firms, and cost of capital is comparatively lower for firms with strong connections than firms with weak connections (Boubakri, Guedhami, Mishra, and Saffar, 2012). Further, the authors suggest that politically connected firms are less risky, because investors of politically connected firms require a lower cost capital than non-connected firms.

In ASEAN countries, prior studies have shown how politically influenced firms get benefits. For instance, Crispin (2002) claimed that a Thai telecom company with a name Shin Satellite, whose 53% of the shares bought by the family of former Prime Minister Thaksin, made a 12 billion USD deal with Burmese military-government-controlled firm after an official visit to Thailand by Burma's intelligence chief. Similarly, in Indonesia, with the approval of President Suharto's the TexMaco group received large loans from one of Indonesia's largest state-owned bank, which was more than the bank's legal lending limit. The founder of the TexMaco Marimutu Sinivasan is known to be a close friend of Suharto (Solomon, 1999). In Malaysia, it is argued that government employed capital controls in 1998 as a trick to help politically influenced firms recovering from the 1997 Asian financial crisis (Johnson and Mitton, 2003). In addition, using Indonesian firms' data, prior study document that political connections

heavily affect the values of firms, and firms' value depends on political connections (Fisman, 2001).

In Malaysia, previous study investigates the relationship between political connections and effective tax rates (Adhikari, Derashid and Zhang, 2006). The authors state that the politically influenced firms pay significantly lower taxes compared to non-politically influenced firms. The authors suggest that the developing economies tend to be "relationship-based" rather than "market-based" capitalisms and therefore, political connections are an important determinant of effective tax rate in developing economies. Moreover, using Malaysian firms' data, Gul (2006) examine the correlation between political connections and audit fees. The author argue that the politically connected firms in Malaysia are related to high audit fees, because connected firms exhibit financial misstatements and report poor quality of earnings.

Using Indonesian firms' data, Leuz and Oberholzer-Gee (2006) declared that political influences do not only change firms' financing strategies; they also impact long-run performance. The study also revealed that politically influenced firms face difficulty to re-establish connections with a new government when their patron falls from power, this lead politically influenced firms to underperform in new government and subsequently depend more on foreign financing and other sources of finance.

In China, prior studies investigate the relationship between political connections and rent-seeking activities. For example, Minggui, Yafu, and Hongbo (2010) find that firms

with political connections get more subsidies compared to non-politically connected firms. Other researchers argue that entrepreneurs' connections with the ruling communist party have a positive effect on their firm performance (Li, Meng, Wang, and Zhou, 2008), because their connections help to obtain loans from financial institutes and banks, and provide legal support. In addition, Wu, Wu, Zhou, and Wu (2012) document that politically connected firms outperform those firms without such connections, because connected firms enjoy tax benefits.

Moreover, Wu, Wu, and Rui (2010) document that firms with politically connected managers obtain more government subsidies and exhibit higher value compared to firms with non-politically connected managers. Further, the authors suggest that state-own firms with politically connected managers employ surplus workers and exhibit lower value than those without politically connected managers.

In America, using Brazilian firms' data, some researchers investigate the relationship between political donations and stock returns (Claessens, Feijen, and Laeven, 2008). The researchers report that political donations are related to higher stock returns during elections, and that contributing firms substantially increased their bank leverage relative to a control group after each election, indicating that investors receive political favors from politically influenced firms. Moreover, Using United States firms data, Goldman, Rocholl, and So (2009) examine the relationship between the politically influenced board members and stock returns. The study finds that the nomination of politically influenced person on board of directors is positively related to abnormal stock returns.

The study also finds that the stock-price of the firms connected to the winning political party increase in value, and firms connected to the losing Party decrease in value.

Interestingly, Jayachandran (2006) used events and news related to American politicians. Jayachandran (2006) used political donations to proxy how much firms are aligned with political parties. The author reported that when Senator Jim Jeffor switch his political party in May 2001, which gave the Democrats power to take over the leadership positions, confirmation of Presidential appointees, chairmanships of the Senate committees and gained influence over the legislative agenda, and more. With this move, firms which gave political donations to the Republicans in the previous elections lose on average 0.8% of market value for every $250,000 they contributed to the Republicans (Jayachandran, 2006).

Using European countries data, prior studies investigated the impact of political influences on organizational performance, stock returns, and employability (Amore and Bennedsen, 2013; Asquer and Calderoni, 2011; Menozzi, Urtiaga, and Vannoni, 2011; Dombrovsky, 2008). Using Italian firms' data, Asquer and Calderoni (2011) empirically show that political influences have adverse effect on performance. The study also revealed that the political influence through opposition party have no significance effect on firm performance, whereas maintaining links with future ruling party have positive effect. Similarly, using Latvian firms' data, Dombrovsky, (2008) show that firms experience a decline in sales in the year when politician joins, followed by a sharp recovery in the following years. The authors suggest that politicians join firms in financial distress and helps with political favors.

Using Italian firms' data, it is opined that political connections make measurable firms' specific benefits that could reduce economic welfare of the people (Amore and Bennedsen, 2013). Some researchers opine that politically connected firms have a negative impact on firm performance, because connected firms employ surplus workers (Menozzi, Urtiaga, and Vannoni, 2011).

On the other hand, Faccio (2006) deeply investigated the effects of political influences on firms. Particularly, political influences are common in countries that are perceived as being highly corrupt. Political influences are less common in the presence of law or regulation of political conflicts of interest. The study further revealed that the value of political influences increase more when a businessperson is prime minister, rather than assembly or parliament member.

In South Asia, various studies in the political influence literature concentrate on different forms of benefits that firms can receive through political influences. These benefits include tax rebates or discounts, relaxed rules and regulations for the politically influenced firm, preferential treatment by state-owned firms such as banks providing loans on low interest rates, preferential treatment in getting government licensing and contracts, paying lower prices to farmers (Saeed, Belghitar, and Clark, 2015; Sukhtankar, 2011; Khwaja and Mian, 2005).

Using Indian firms' data, Sukhtankar (2011) investigates an alternative mechanism through which politicians may generate political campaign funds. The author documents that during the election year; politically connected sugar mills pay lower prices to farmer for sugar cane, because later politicians may recompense farmers upon getting elected. Using Bangladeshi firms' data, Bardhan, Mitra, Mookherjee, and Sarkar (2009) found that political connections constraints the implementation of good governance practices. Other authors argue that politically connected family firms outperform family firms without such connections (Muttakin, Monem, khan, and Subramaniam, 2015).

Pakistan is not excluded in respect of political connections. For example, Khwaja and Mian (2005) find that politically influenced firms obtain preferential treatment from state-owned banks. Khwaja and Mian (2005) further document that politically influenced firms get 45% more loans compared to non-politically influenced firms and have 50% more default rates compared to non-politically influenced firms. Moreover, ruling party gets easy access to financial market than opposition party, which shows the practice of political power (Khwaja and Mian, 2005). The study further reveals that the economic lost to the economy of these preferential lending is between 0.30–1.9 percent of GDP annually. The authors explain that politically influenced firms are related to high debt ratio, because connected firms have easy access to loans or debts, and they are able to get loans on lower interest rate.

In addition, Saeed, Belghitar and Clark (2015) using data of Pakistani firms, investigate the impact of political influences on firms' financing decisions. The study finds that

there is a significant and positive relationship between political influences and long-term loans/debt, which shows that there is an easy access to loans. The study further reveals that preferential treatment and easy access to loans vary with political strength and the size of firms.

Recently, Cheema, Munir, and Su (2016) examine the relationship between political connections and firms' performance in Pakistan. The study finds a negative relationship between political connections and organizational performance, because politically connected firms manipulate earnings to cover and hide their political gains (Chaney, Faccio, and Parsley, 2011). Particularly, if the political gains are large and obtained through dubious legality, then their political gains and benefits need to be hidden (Fisman, 2001), through earnings management activities (Chi, Liao, and Chen, 2016; Braam, Nandy, Weitzel, and Lodh, 2015; Al-dhamari and Ismail, 2015; Chaney, Faccio, and Parsley, 2011).

Therefore, this research expands previous literature on the determinants of earnings quality. The determinant variable in this research is firms' political influences. This study investigates the impact of political influences on manager's reporting, which consequently affects the quality of reported earnings between politically influenced firms and non-politically influenced firms in Pakistan.

2.8.3 Impact of Political influences on earnings quality

Previous studies have shown two important ways through which political influences can impact earnings quality of politically influenced firms. First, governments might pressurize politically influenced firms to hide information regarding expropriation activities exercised by their cronies (Bushman, Piotroski, and Smith 2004). Second, since politically influenced firms get benefits from their political connections, managers of these firms may have incentives to obscure information in relation to benefits received with the intention to increasing their wealth at the expense of outside investors (Chaney, Faccio, and Parsley, 2011). In this regard, enough evidence from previous studies has shown the negative relationship between political influences and earnings quality (Chi, Liao, and Chen, 2016; Liu, Li, Zeng, and An, 2016; Al-dhamari and Ismail, 2015; Braam, Nandy, Weitzel, and Lodh, 2015; Chaney, Faccio, and Parsley, 2011; Ramanna and Roychowdhury, 2010). These studies also reveal that earnings quality is ultimately shaped by political influences or factors, which influences the financial reporting incentives of management. This argument is based on a basic principle that political influences create incentives that influence the behavior of managers who prepare the financial statements. Such incentives affect the earnings quality through political connections.

Using multiple-countries' data, some authors opine that politically connected firms exhibit poor earnings quality (Ben-Nasr, Boubakri and Cosset, 2015; Chaney, Faccio, and Parsley, 2011; Makar and Alam, 1998), because politically connected firms manipulate earnings to avoid political costs during economic boom (Makar and Alam,

1998), and hide the political benefits, which they receive through dubious legality (Chaney, Faccio, and Parsley, 2011). Similarly, Ben-Nasr, Boubakri, and Cosset (2015) show that politically influenced firms through state-ownership provide lower earnings informativeness, and report less persistent earnings.

In addition, Riahi-Belkaoui (2004); Ball, Robin, and Wu (2003) using multiple countries data find that political influences are an important factor to impact financial reporting, and adopting better accounting standards only does not guarantee high earnings quality. Some scholars argue that political economy is related to financial transparency (Bushman, Piotroski, and Smith, 2004). The authors further argue that firms in countries with lower government ownership are related to better financial reporting practices. Correia (2009) reveals that firms with greater political expenditures have lower earnings quality, because firms with political influences increase their expenditures during the period of misreporting.

Moreover, some researchers state that political influences are related to lower quality of accruals compared to non-politically influenced firms (Chaney, Faccio, and Parsley, 2011). The study also states that the stronger type of political influences are maneuvered through ministers or head of state rather than members of national or provincial assembly, who are rather related to only lower quality of accruals. Further, the authors claim that politically influenced firms face less negative outcomes for reporting lower earnings quality. In a recent study, the authors suggest that political connections play a significant role in the choice between earnings management

strategies (Braam, Nandy, Weitzel, and Lodh, 2015). He opines that politically connected firms substitute real earnings management (REM) for accruals earnings management (AEM), because REM is less detectable by the regulatory bodies.

In East Asia, using Chinese firms' data, previous studies have shown the negative relationship between political influences and earnings quality (Chi, Liao, and Chen, 2016; Liu, Li, Zeng, and An, 2016; Guo and Ma, 2015; Liu, Saidi, and Bazaz, 2014; Li, Griffin, Yue, and Zhao, 2013; Srinidhi, Zhang, and Zhang, 2012; Wang and Yung, 2011; Li, Selover, and Stein, 2011). Consistent with Braam, Nandy, Weitzel, and Lodh (2015), some authors argue that firms with politically connected CEOs are engaged in lower level of accruals-based earnings management and higher level of real earnings management (for example, Chi, Liao, and Chen, 2016). Further, the authors claim that non-state owned firms with politically connected CEOs are involved in higher level of accruals earnings management. Similarly, in a very recent study, researchers opine that politically connected firms report poor earnings quality (Liu, Li, Zeng, and An, 2016). This is because the quality of audit decreases in firms with strong political connections, since firms with strong political connections have comparatively more manipulated accounting records. Consistent with Liu, Li, Zeng, and An (2016), Srinidhi, Zhang, and Zhang (2012) provide evidence that politically influenced firms are unwilling to engage big auditors compared to non-politically influenced firms, because politically influenced firms exhibit higher discretionary accruals and less timely recognize losses.

Recently, Guo and Ma (2015) document that the existence of several state representatives in state-owned firms increases accruals earnings management. The study also shows that earnings management lack incentives when a state representative is the major shareholder, because then the firm have easy access to market and resources. In a similar study, using multiple measures of earnings quality, some authors claim that firms with significant government shareholding recognize losses less frequently and involve more in earnings smoothing, managing earnings towards target, and reporting less value relevant earnings (Liu, Saidi, and Bazaz, 2014). Further, the authors claim that state-owned firms provide regulatory backing and create incentives for self-serving purpose, which negatively influences earnings quality.

Moreover, Li, Griffin, Yue, and Zhao (2013) relate earnings management activities of politically influenced firms with tax rates. The authors state that politically connected firms are only involved in tax induced earnings management (TEM) when the tax rates are increased; because this could help the politically connected firms to reduce tax burden and avoid being punished. In contrast, other researchers argue that earnings quality become less relevant between politically and non-politically influenced firms when economy is more market driven (Wang and Yung, 2011).

In Southeast Asia, using Malaysian firms' data, Al-dhamari and Ismail (2015) document that politically connected firms report poor earnings quality, because such politically connected firms are involved in accruals earnings management. The authors also claim that politically connected firms with high cash reserves report higher

earnings quality. On the other hand, using Indonesian firms' data, some authors argue that government effectiveness reduces the political gains of connected firms, which result in higher earnings quality (Harymawan and Nowland, 2016). However, the authors state that political stability enhances the certainty of political gains from political connections, which reduce the need for politically connected firms to respond to market pressures and result in lower earnings quality.

Using data of European countries, prior studies report that politically influenced firms' exhibit poor earnings quality (Bona-Sánchez, Pérez-Alemán, and Santana-Martín, 2014; Capalbo, Frino, Mollica, and Palumbo, 2014). While using Spain firms' data, Bona-Sánchez, Pérez-Alemán, and Santana-Martín (2014) reveal that when the boards of director(s) are politically influenced; it affects firms' financial reporting choices. The study also finds that political boards of director(s) are involved in disclosing as little information as possible in order to protect political connections from scrutiny. Therefore, political influences are related to less transparency. In addition, Capalbo, Frino, Mollica, and Palumbo (2014) claim that state-owned firms are more involved in earnings management with high profits and decreases with firm size.

Using USA firms' data, Ramanna and Roychowdhury (2010) find that politically connected firms are more engaged in income decreasing earnings management during election period, in order to hide the political gains that they receive through connections (Chaney, Faccio, and Parsley, 2011). Similarly, using Indian firms' data, Narayanaswami (2013) reveal that politically connected firms are more likely to involve

Big Four auditors than non-connected firms in order to avoid scrutiny by regulatory authorities, because connected firms are engaged in manipulating earnings and report significantly lower quality of earnings.

Table 2.2
The review of politically influenced firms: Major results of empirical studies

Authors	Results
Chi, Liao, and Chen (2016)	• Firms with politically connected CEOs engage in higher level of real earnings management and lower level of AEM. • Non-state owned firms with politically connected CEOs engage in higher level of AEM.
Liu, Li, Zeng, and An (2016)	• The quality of audit increases with weak political connections and vice versa for strong political connections. • The study shows the negative relationship between political connections and earnings quality.
Al-dhamari and Ismail (2015)	• Politically connected firms are related to lower earnings quality in Malaysia. • The study also finds that earnings with high cash reserves are of high quality

Table 2.2 (Continued)

Authors	Results
Guo and Ma (2015)	• The study finds that existence of several state representatives in state-own firms increase accruals earnings management. The study also reveals that earnings management lack incentives when a state representative is the major shareholder, because then the firm has an easy access to market and resources.
Zeng, Li, and Hong (2012)	• Political connections negatively affect earnings quality of listed firms in China.
Batta et al.(2014)	• Politically connected firms have higher EQ than non-connected firms in Venezuela. Venezuelan politically connected firms are not involved in earnings smoothing and accruals earnings management.
Bona-Sánchez, Pérez-Alemán, and Santana-Martín (2014)	• Political connections negatively influenced firms' earnings informativeness and affects financial reporting choices of firms. • Shareholders and politicians are interested in providing little information to the market in order to protect political links from public scrutiny.
Capalbo, Frino, Mollica, and Palumbo (2014)	• State-owned firms involve more in earnings management with high profits and decreases with firm size.

Table 2.2 (Continued)

Authors	Results
Ben-Nasr et al. (2014)	• State ownership adversely affects stock price informativeness and it is more pronounced in countries with lower political rights. • The study also finds that state ownership is related to less transparency.
Liu, Saidi, and Bazaz (2014)	• Firms with significant state ownership exhibit lower earnings quality. • State-owned firms' earnings are less value relevance, involve more in earnings smoothing, manage earnings towards target and less frequently recognizes losses.
Srinidhi, Zhang, and Zhang (2012)	• Politically influenced firms exhibit lower transparency than non-influenced firms in China. • These firms exhibit higher discretionary accruals compared to non-politically influenced firms, less timely recognize losses, and are unwilling to engage big4 auditors.
Li et al. (2013)	• Politically connected firms are only involved in tax induced earnings management (TEM) when the tax rates are increased. Because this could help connected firms to reduce tax burden and avoid being punished.

Table 2.2 (Continued)

Authors	Results
Guedhami et al. (2013)	• Politically influenced firms with Big4 auditors enjoy greater transparency and exhibit less earnings management.
Narayanaswamy (2013)	• Connected firms have significantly lower quality of earnings compared to non-connected firms in India. • Politically influenced firms are more likely to involve Big Four auditors than non-connected firms in order to avoid scrutiny by regulatory authorities.
Chaney, Faccio, and Parsley (2011)	• Politically connected firms have poorer earnings quality than non-connected firms because connected firms can afford to disclose lower earnings quality.
Li et al. (2011)	• State-owned firms are linked to high earnings management. Chinese managers choose accruals policies that result in slightly positive profits.
Ramanna and Roychowdhury (2010)	• Politically influenced firms with extensive outsourcing activities have more income-decreasing discretionary accruals implying lower earnings quality. The earnings are managed through income-decreasing discretionary accruals during election year.

2.9 Earnings Management Motivations in Politically Influenced Firms

One could have argued that political influences are related to better organizational performance. This is because; politically influenced firms have easy access to long term loans (Khwaja and Mian, 2005), government contracts (Saeed, Belghitar, and Clark, 2015), and get preferential treatments (Pastor and Veronesi, 2013; Faccio, 2010). Some empirical evidences have shown the fact that political influenced firms obtain political gains from their connections (Chaney, Faccio, and Parsley, 2011; Faccio, 2010).

However, this is not often the case. Prior studies exemplify that political influences are associated with poor organizational performance (Cheema, Munir, and Su, 2016); because politically influenced firms are involved in income-decreasing earnings management activities in order to report less taxable income (Li, Selover, and Stein, 2011; Ramanna and Roychowdhury, 2010), and hiding political gains which they obtain through dubious legality (Sadiq and Othman, 2017; Chaney, Faccio, and Parsley, 2011).

Some studies found that political influenced firms are under media or public monitoring compared to non-politically influenced firms (Chaney, Faccio, and Parsley, 2011). Consequently, if the political gains and benefits are of dubious legality and large then their political connections need to be hidden (Fisman, 2001). Therefore, to hide their political benefits; politically influenced firms could get involved in income-decreasing accruals earnings management to report poor organizational performance.

In addition to income-decreasing accruals earnings management activities, politically influenced firms are engaged in real earnings management activities in order to avoid detection by the regulators (Braam, Nanday, Weitzel, and Lodh, 2015). Further, the authors opine that politically influenced firms substitute real earnings management strategy for accruals earnings management to confuse the regulators and it is then less likely for the regulators to detect the manipulation activities.

2.10 Control Variables

Control variables play a vital role in examining whether the relationship between the independent variable (political influence) and dependent variable (earnings quality) is affected by other correlated factors, and control firms' characteristics. In the existing state of political influence and earnings quality, researchers have used some sets of variable as control variables. For instance, firm size (SIZE), profitability (ROA), financial leverage (LEV), growth opportunities (GROWTH), audit quality (BIG4), and LOSS may be important determinant of the quality of earnings that have been widely used in prior research (e.g. Al-dhamari and Ismail, 2015; Chaney, Faccio, and Parsley, 2011; Mashayekhi and Bazaz, 2010; Dimitropoulos and Asteriou, 2010; Cho and Rui, 2009; Sivaramakrishnan and Yu, 2008; Cheng and Warfield, 2005). Therefore, this study uses these variables in order to explain their significant impact on earnings quality. The following subsections discuss the relationship between the control variables and the quality of earnings.

2.10.1 Firm Size

Large firms can utilize effective internal control system compared to small firms, and markets believe that large firms have high earnings quality. Petra (2007) for example, states that the markets react more favorably to reported earnings produced by large firms compared to small firms. Vafeas (2000) provides evidence that returns-earnings relationship is stronger for large firms.

Makar and Alam (1998) claim that firms adopted income-decreasing earnings management strategy in order to decrease political costs. Consequently, this would ultimately deteriorate the earnings quality of large firms. Sivaramakrishnan and Yu (2008) argue that earnings quality decreases as firm size increases. On the contrary, Machuga andTeitle (2009) find that small firms have high earnings quality in terms of abnormal accruals, timely loss recognition, and income smoothness. Dimitropoulos and Asteriou (2010) find that large firms experience less earnings quality, analyzed through abnormal accruals. In similar study, Epps and Ismail (2009) give evidence that managers in large firms involve in opportunistic behavior of earnings management.

2.10.2 Audit Quality

Firms are perceived to disclose high earnings quality when their financial statements are audited by BIG4 auditors (Gul, 2002). Some authors argue that audit quality constrains managerial reporting discretion, and thus reduces information risks (Chen, Ding, and Kim, 2010). In contrast, prior studies document that BIG4 auditors only limit accruals

earnings manipulation, and are unable to constrain real earnings management. For example, Chi, Lisic, and Pevzner (2011) suggest an unintended consequence of higher quality auditors constraining accrual earnings management, namely, firms resorting to potentially even more costly real earnings management. Further, the study claims that high audit fees are related to higher levels of real earnings management. Following prior studies such as Al-dhamari and Ismail (2015); Chaney, Faccio, and Parsley (2011); Mashayekhi and Bazaz (2010); Cheng and Warfield (2005); Reynolds and Francis (2000) BIG4 is represented by an indicator variable taking the value of one (1) if a firm is audited by one of the big four auditing firms and zero (0) if otherwise.

2.10.3 Leverage

Leverage is measured as total liabilities divided by total assets. Cho and Rui (2009) and DeAngelo (1994) state that leverage represents the riskiness of debt or default, and thus earnings quality is low as the probability of default in debts or liabilities increases. Moreover, Gul and Lai (2002) reveal that leveraged firms produce less earnings informativeness. Similarly, Petra (2007) gives evidence that leverage is negatively related to earnings informativeness. Following Al-dhamari and Ismail (2015); Chaney, Faccio, and Parsley (2011); Mashayekhi and Bazaz (2010); Cheng and Warfield (2005); Reynolds and Francis (2000), this study measures firms leverage by dividing long term liabilities or debts to total assets.

2.10.4 Return on Assets (ROA)

Managers in firms producing lower return on assets are probably to involve in opportunistic behavior of earnings management to avoid negative return on assets, and thus the earnings quality of these firms deteriorates. Velury and Jenkins (2006) argue that firms with negative ROA take longer time to announce earnings. Similarly, Vafeas (2000) find that negative ROA has a negative impact on the usefulness of earnings to financial information users. Zhao and Chen (2008) gives evidence that negative ROA is inversely related to earnings quality.

In addition, Jaggi (2009) finds that firms with good operating performance report high earnings quality; and therefore earnings quality increases as profitability or ROA increases. Following Al-dhamari and Ismail (2015); Chaney, Faccio, and Parsley (2011); Mashayekhi and Bazaz (2010); Cheng and Warfield (2005); Reynolds and Francis (2000) ROA is measured as net income before extraordinary items divided by average total assets.

2.10.5 Loss

Prior studies have shown the positive relationship between loss and earnings management. For instance, Burgstahler and Dichev (1997) document that firms manage reported earnings to avoid reporting losses. Similarly, Maydew (1997) opines that firms with net operating losses are involved in tax-induced earnings management activities. Firms often manipulate earnings to avoid reporting small losses (Burgstahler, Hail, and Leuz, 2006). To avoid reporting annual losses, Roychowdhury (2006) provides

evidence that managers manipulate earnings through real earnings management. Similarly, Cohen and Zarowin (2010) provide evidence that firms use multiple real earnings management methods, in order to meet certain financial reporting benchmarks to avoid reporting annual losses.

2.10.6 Growth

Firms with high growth over-report earnings by a larger amount because stock price responsiveness increases with firms' growth (Lee, Li, and Yue, 2006). Furthermore, some authors claim the positive relationship between earnings management and growth. For example, Richardson, Tuna, and Wu (2002) argue that firms manipulate earnings to maintain consecutive growth. In addition, Bergstresser and Philippon (2006) associate high growth with inflated earnings. On the contrary, some authors claim that firms manipulate earnings through real activities management in order to increase sales. For instance, Cohen and Zarowin (2010); Roychowdhury (2006) suggest that managers are providing price discounts to increase sales.

2.11 Underpinning Theory

2.11.1 Agency Theory

This study investigates the relationship between political influences and earnings quality. Although there is a literature which relates political influences to earnings quality (for instance, Sadiq and Othman, 2017; Al-dhamari and Ismail, 2015; Braam, Nandy, Weitzel, and Lodh, 2015), there is no particular theory that directly relates political influences and earnings quality. This study employs agency theory to link both variables.

Agency theory elucidates the basis of conflicts and ways to curtail the conflicts that can arise between parties in an agreement (Jensen and Meckling, 1976). In a listed firm, the parties that are involved in an agreement are shareholders (the principals) and managers (the agents). Jensen and Meckling (1976) mention that a company is a place of formal and informal agreements under which shareholders elect another person as their agent (director or manager) to make decisions on their behalf, which requires delegations for the decision making to the agents. Therefore, agency theory recognizes the relationship between shareholders and managers. Shareholders may include government shareholding and other institutions (Hill and Jones, 1992).

Agency theory also explains that the conflict between managers and shareholders occur when they have contrary interest. For instance, the actions of the managers do not meet the interest of the shareholders. Managers or agents are perceived to take decisions that capitalize on their self-interest and do not satisfy the interests of shareholders or principal (Jensen and Meckling, 1976). This conflict causes cost to the shareholders which is known as conflict or agency cost (Watts and Zimmerman, 1990).

In firms where the government owned significant shareholdings, conflicts may occur more between principal and agent (Shliefer and Vishny, 1994). In such firms, the principal-agent relationship is broken down into two other agency relationships as the government act simultaneously as principal and agent. In relation to the managers of government-owned firms, the government is a principal and thus it must assign goals

(Rodriguez, Espejo, and Cabrera, 2007). The government is also the agent in its relationship with the public, the ultimate owner of the resources invested in by the government-owned firms (Ernst, 2004). The government not only considers the public interest as voters in decision making process, but also the agendas of the opposition parties that compete for votes. Therefore, the government wants to control managerial decisions so that the decisions are congruent with its political interests. The government may use its political influences to interfere with firms' operational decisions (Chen, 2004). For instance, the government may put pressure on managers to provide benefits to its supporters or stabilize employment and induce them to drift beyond profit-maximizing goals (Roe, 2003). In this study, the government is supposed to have influence on managerial decisions through significant shareholdings, appointing politicians and bureaucrats(s) as its representative on the board of directors and management.

Political influence can occur in any firms other than government-owned firms. Hillman (2005) reveals that firms build relationship with the government to get benefits, and the best way to build the relationship is to appoint a politician on the board of directors. This relationship is assumed to be able to decrease the effects of government policies, enforcements and regulations. Such relationships could improve firms' performance through protecting them from external threats and fluctuations (Hillman, 2005). Further, political influences also occur in a firm when a firm is significantly owned by politician(s) or their close relative(s) (Cheema, Munir, and Su, 2016; Faccio, 2006). Politically influenced firms through any aspects enjoy benefits in form of lower taxes,

high debts and lower interest rates (Saeed, Belghitar, and Clark, 2015; Faccio, Masulis, and McConnel, 2006; Fisman, 2001).

However, the association of politicians with a firm can create double agency problem involving self-centered behavior by both politicians and managers (Wong, 2004). Some researchers opine that people engaged in the political process are self-centered actors who want to maximize their own interests which may curtail the interests of the majority shareholders (e.g., Tullock, 2003). For instance, politicians may create a connection between government agencies and managers, which may give firms a preferential access to loans and in return firms may give political donations (Hillman and Pitt, 1999).

Further, negotiation between managers and politicians could take place in order to maximize their own interest (Sheleifer and Vishny, 1994). The authors argue that when a firm is controlled by managers, politicians engaged in the firms use subsidies as bribes to influence managerial decisions in order to pursue their political objectives. Thus, the involvement of politicians in a firm can affect managerial decisions, and consequently may affect the outcomes of the firms' economic objectives. The current study looks at the earnings quality as the outcomes.

Generally, the interference from the politically influenced people and government in firms may also give the impression that autonomy of management decisions has not been met, because it discourages managers to monitor firm's success, which may lead

management to pursue its own interest at the cost of shareholders' interests (Chen and Jia, 2005). Other than creating agency problem by politically influenced firms through political interference, the accounting systems of the firms may also be affected. This is because agency problems and accounting systems of the firms are closely related (Tagesson, 2007). Politically influenced firms may adopt an accounting system which allow them to publish and report information that is best for their interests (Zimmerman, 1977).

In short, agency theory makes a framework that relates political influences and earnings quality. This study concentrates on the effect of political influences on earnings quality in Pakistani firms. In current study, politically influenced firms are assumed to occur through significant shareholding by government; presence of politician(s) or closed relative(s) of politician(s) in a firm; presence of current/former civil/military bureaucrat(s) in a firm.

2.12 Supporting Theory

2.12.1 Classical Political Economy Theory

Classical political economy theory highlights the structural conflict within the society. It clarifies corporate disclosure as being a tool by which a powerful individual maintain their self interest (through targeted information disclosures) to the detriment of those individuals without power (Deegan, 2006).

Gray, Owen, and Adams (1996) define political economy theory as:

"Political economy theory is the social, political, and economic framework within which human life takes place. Political economy theory explicitly recognizes the power conflicts that exist within society and various struggles that occur between various groups within society. The perspective embraced in political economy theory is that society, politics, and economics are inseparable and economic issues cannot be meaningfully be investigated in the absence of considerations about the political, social, and institutional framework in which the economic activity takes place. It is argued that by considering the political economy a researcher is better able to consider broader issues which impact how an organization operates and what information it elects to disclose."

Further, some researchers argue on the relevance of accounting and disclosures in political economy (Guthrie and Parker, 1989). The Guthrie and Parker (1989, pg. 166) argue that:

"The political economy perspective perceives financial reports as political, social, and economic documents. They serve as a tool for constructing, sustaining, and legitimizing economic and political arrangements, institutions, and ideological themes which contribute to the corporation's private interests. Disclosures have the capacity to transmit social, political, and economic meanings for a pluralistic set of report recipients."

2.13 Literature Gap

In recent years many studies have investigated the relationship between political influences and earnings quality. There is enough literature available on the issue. However, there is still a need to investigate the relationship between political influences and earnings quality in more detail. The review of past literature shows that many studies pay attention on the relationship between political influences and earnings quality. However, most of the studies have used multiple-countries data and single aspect of political influences and attribute of earnings quality.

To the best of knowledge, none of the prior studies has investigated political influences (presence of politician(s) or close relative(s) of politician(s) in a firm; significant shareholding by government; and presence of current/former civil/military bureaucrat(s) in a firm) and earnings quality (real earnings management, accruals earnings management, and earnings aggressiveness) using these proxies simultaneously. According to Al-dhamari and Ismail (2015); Zeng, Li, and Hong (2012) political influences and earnings quality need to be investigated in more details with multiple attributes. This is because; earning quality is a multifaceted concepts and using only single attribute may not provide a good indicator of earnings quality. In a recent study, Braam, Nandy, Weitzel, and Lodh (2015) argue that using only accruals or real earnings management attribute underestimates the overall earnings management activities of a firm. Further, the authors suggested that future studies should employ both accruals and real earnings management attributes of earnings quality in order to capture the overall

earnings management activities of a firm. Therefore, employing both accruals and real earnings management offers a good indication of earnings quality.

This research is different from previous studies in several ways. First, previous studies mostly use only one or two earnings quality attributes as the measure of earnings quality, while this study uses three attributes as proxies of earnings quality. Second, this study uses three main aspects of political influences. Third, to give more insight, current study investigates whether there is a difference in effect between ruling/opposition party political connections on earnings quality. Fourth, current study uses both proxies of earnings management i.e. accruals earnings management and real earnings management simultaneously, which is being used by very limited studies. Fifth, following Braam Nandy, Weitzel, and Lodh (2015) current study also investigates whether politically influenced firms substitute real earnings management strategy for accruals earnings management. However, unlike Braam Nandy, Weitzel, and Lodh (2015), this study employs three aspects of political influences instead of single aspect of political influences and uses single-country data (i.e. Pakistan) instead of multiple-country data. Using one country data will overcome some of the criticisms of the multiple-country studies, including difficulties in interpretation and data analysis, noisy variables as a result of differences in cultural, judicial and legal factors. Finally, the Pakistan environment allows an investigation of the relationship between political influences and earnings quality.

This study extends previous literature on the effects of institutional factors on earnings quality. The institutional variable in current study is firms' political influences, i.e. firms' political links with politician(s) or political party, significant government shareholding, close relatives of politician(s), and senior manager(s) is a current/former civil/military bureaucrat(s). Particularly, this research proposes that the existence of political influences impact manager reporting incentives which as a result causes systematic differences in the quality of reported earnings between politically influenced firms and non-politically influenced firms in Pakistan.

2.14 Summary

Chapter two discusses literature review of earnings quality and political influences. Initially it presents different contextual definitions of earnings quality followed by earnings quality measurements adopted by current study. This chapter also discusses and compares different measurements of earnings quality to be used in this study. In addition, it examines such previous studies that discuss determinants that affect earnings quality. It has also provided a discussion on independent variable i.e. political influences and its multiple aspects, followed by impact of political influences on different variables in the whole world and particularly in Pakistan. Moreover, this chapter discusses previous studies on political influences and earnings quality and provides results of these studies. It also provides the summaries of previous studies on political influences and earnings quality. The control variables used by previous studies to regress earnings quality and political influences have also been highlighted. Further, next section discusses the underpinning theory i.e. agency theory followed by the

supporting theory i.e. political economy theory. Finally, this chapter presents literature gap of current study.

The next chapter gives explanation of theoretical framework, development of hypotheses, and the research methodology to be used in the current study. In addition, the next chapter also discusses data collection, study period, sample selection and model specifications used in the current study.

CHAPTER THREE

METHODOLOGY

3.0 Introduction

The review of related empirical studies in the previous chapter sets the direction and identifies research gaps of the current study. This chapter provides the research methodology; develops the theoretical framework to test the hypotheses of this study in relation to earnings quality; presents the methodological aspects of current study; and discusses a selected sample. The current study has used secondary data which was collected from politically influenced firms' annual reports and financial databases. In addition, a quantitative approach is also employed to achieve the objectives of the study.

The chapter is organized in the following manner: first this chapter discusses the theoretical framework; followed by the measurements of variables and development of the hypotheses; next section introduces the data collection and sample specification of the study; and method of analysis.

3.1 Theoretical Framework

The current study argues that political influences occur through significant government shareholding, the presence of politicians and their close relative's presence in a firm, and the presence of civil/military bureaucrats in a firm. In this regard, current study examines political influences in Pakistani firms. These firms include firms with significant government shareholdings and non-government owned firms with

politician(s) or former bureaucrat and army officer appointed in senior management and board of directors.

The current study argues that government has a control and influence over a firm through significant shareholding by government and by appointing politicians or current/former bureaucrats as representatives in the senior management. Political influences can also occur in private firms with the presence of politicians in the senior management.

Within the framework of agency theory, the current study argues that in the government-owned firms, agency conflict can happen between (1) the government (principal) and the managers (the agents); (2) the politician(s) as the government's representatives on the board (the agent) and the government (the principal); (3) the managers (the agents) and the politician(s) or their relatives (the principal); and (4) the current/former civil/military bureaucrat (the agent) and other shareholders (the principals). The government can directly control and influence over its owned firms by imposing rules and regulations and its policies in order to achieve political agenda. The decisions of the managers influenced by the government may conflict with the manager's financial interests.

Moreover, the government controls or monitors managers' decisions and actions by appointing politician(s) as its representative(s) in the senior management or board of directors. Whereas, a politician(s) as the governments' representative(s) can use their

political influences to influence the managers for their personal interests. These personal interests may contradict with the firms' economic objectives and the government policies. The current study argues that the influence of politicians on the senior managers can also occur in a firm which is privately owned and not owned by the government, but appoints a politician(s) to its board to create connections with the government. Therefore, it is expected that political connections can influence managers' decisions and actions. In current study, political connections and earnings quality are examined.

Prior studies discussed in previous chapter, indicate that political influences significantly affect earnings quality. However, most previous studies reviewed confine political influence to a particular measure such as government ownership or political donations etc. The current study is using three aspects of political influences simultaneously i.e. political connections through the presence of politician(s) and their close relatives in a firm; significant government ownership; and the presence of current/former civil/military bureaucrat(s) in a firm. In relation to earnings quality, the current study uses three attributes of earnings quality i.e. accruals earnings management, real earnings management, and earnings aggressiveness.

Following figure summarizes the framework of the study. As shown in the figure that political influences have three main aspects and earnings quality are measured by three different attributes. The expected connections between the two variables (i.e. political

influences and earnings quality) as modeled in figure become the framework used to develop the hypotheses of the current study.

Independent Variables

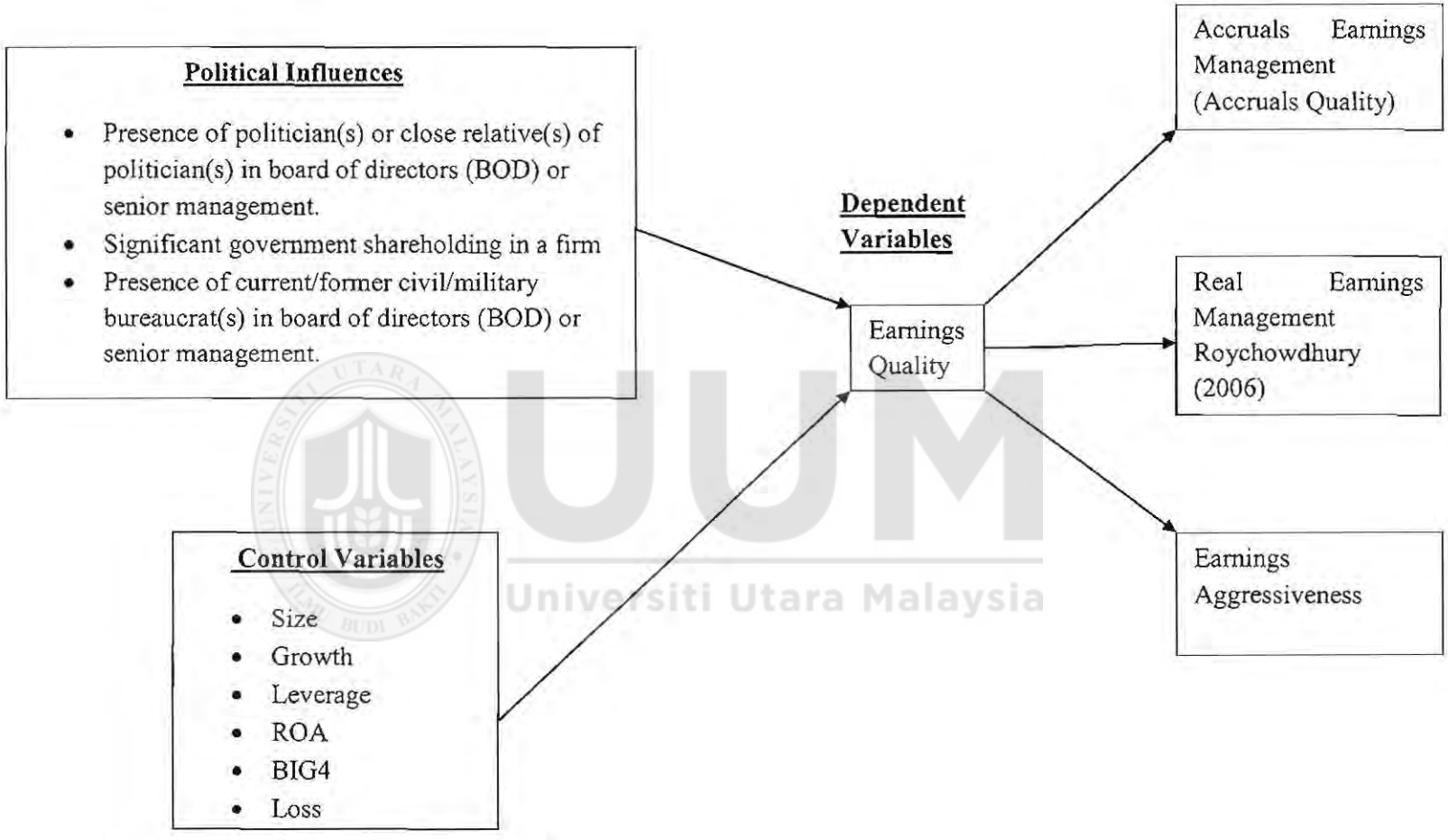

Figure 3.1: Theoretical Framework

3.2 Hypothesis Development

3.2.1 Political Influences and Accruals Earnings Management (Accruals Quality)

One could have argued that political influence is related to better organizational performance, because politically influenced firms have easy access to long-term loans on lower interest rates (Khwaja and Mian, 2005), they easily get government contracts and write-off their loans (Saeed, Belghitar, and Clark, 2015). Some empirical evidence exemplify that politically influenced firms get preferential treatment and gain a lot from their connections (Chaney, Faccio, and Parsley, 2011; Faccio, 2010). However, this is often not the case. Recently, some authors argue that political influences are associated with poor organizational performance in Pakistan (Cheema, Munir, and Su, 2016); because politically influenced firms are involved in accruals earnings management in order to hide political gains (Chaney, Faccio, and Parsley, 2011), and report less taxable income (Ramanna and Roychowdhury, 2010).

In addition, prior studies exemplify that earnings, as a result of the accruals process, gives a better measure of firm performance in comparison to cash flow (e.g., Dechow et al., 2010). However, accruals are often based on estimates, and thus accruals quality decreases as accruals estimation errors increases (Dechow and Dichev, 2002). Fisman (2001) argue that firms with political connections receive political favors such as government contract, subsidies, tax discount, and licenses. Subsequently, political favors increase the transitory component of earnings, because it comes in a windfall fashion which may disrupt the time series pattern of earnings (Chen, Ding, and Kim,

2010), consequently increases chances of estimation errors (Dechow and Dichev, 2002), and thus result in lower accruals quality.

In addition to transitory earnings, some authors opine that political factors influence the incentives of managers who are involved in preparing financial statements (e.g., Bushman, Piotroski, and Smith 2004; Ball, Robin, and Wu, 2003; Ball, Kothari, and Robin, 2000). Other researchers suggest that the magnitude of accruals estimation errors is also influenced by managerial intentions, and managerial intentions are often influenced by political factors (e.g., Bushman and Piotroski, 2006; Ball, Robin, and Wu, 2003).

Moreover, previous studies exemplify that politically influenced firms are more engaged in accruals earnings management activities in comparison to non-politically influenced firms (Sadiq and Othman, 2017; Al-dhamari and Ismail, 2015; Chaney, Faccio, and Parsley, 2011), and report less transparent earnings (Riahi-Belkaoui, 2004). Other studies provide evidence that political connections create incentives for managers to manage earnings (Bushman and Piotroski, 2006; Gul, 2006). Therefore, the quality of accruals decreases in firms with political influences.

H1: Politically influenced firms are more involved in accruals earnings management compared to non-politically influenced firm.

3.2.2 Political Influences and Real Earnings Management

Managers of non-politically influenced as well as politically influenced firms may use both real earnings management and accrual-based earnings management to enhance corporate value. However, after the implementation of Sarbanes-Oxley Act (SOX), new phenomenon could be seen in firms. For example, Zang (2011); Cohen and Zarowin (2010); Cohen, Dey, and Lys (2008) show that after the implementation of SOX, firms are more inclined to use real earnings management instead of accruals earnings management, because real earnings management is not easily detectable (Kothari, Mizik, and Roychowdhury, 2012), and does not come under auditors and regulators jurisdictions (Braam, Nandy, Weitzel, and Lodh, 2015). This phenomenon could also be seen in politically influenced firms. For example, some authors argue that firms with politically connected CEOs are more involved in higher level of real earnings management (Chi, Liao, and Chen, 2016), because detection of accruals earnings management may damage the reputation of the firm and its managers, as well as the social image of a connected politician or political party (Braam, Nandy, Weitzel, and Lodh, 2015). Thus, if accruals earnings management strategy is risky, then politically connected firms are likely to employ less detectable real earnings management strategy to avoid detections.

In addition, some researchers opine that real earnings management reduces political costs of connected firms, maintains the reputation of politically connected firms, weakens the monitoring ability of society, and the likelihood of outside intervention (Braam, Nandy, Weitzel, and Lodh, 2015). Real earnings management reduces the risks

that managers are taking when they get involved in earnings management (Cohen and Zarowin, 2010; Cohen, Dey, and Lys, 2008; Roychowdhury, 2006). Therefore, current study also expected that politically influenced firms are likely to use real activities' manipulation.

H2: Politically influenced firms are more involved in real earnings management compared to non-politically influenced firms.

3.2.3 Political Influences and Earnings Aggressiveness

Firms with high total accruals are considered to be reporting lower earnings quality, because it represents less persistent earnings (Dechow, Ge, and Schrand, 2010), and increases chances of estimation errors (Dechow and Dichev, 2002). Some researchers argue that earnings are considered to be of higher quality, if earnings are closer to cash flow, and contain comparatively small amount of accruals (Visvanathan, 2006; Bhattacharya, Daouk, and Welker, 2003). Bhattacharya, Daouk, and Welker (2003) exemplify that opportunistic overstatement of earnings (earnings management) lead to more positive and fewer negative accruals, that leads to an overall higher level of accruals. Similarly, Leuz, Nanda, and Wysocki (2003) also use the magnitude of accruals as a measure for accruals earnings management. In a recent study, Sadiq and Othman (2017) document that politically influenced firms are more involved in accruals earnings management and report less transparent earnings numbers (aggressive earnings) compared to non-politically influenced firms. Therefore, firms that involved more in accruals earnings management have higher level of accruals.

H3: Politically influenced firms are positively related to earnings opacity (earnings aggressiveness) compared to non-politically influenced firms.

3.2.4 Ruling/Opposition Party(s) Political Connections and Accruals Earnings Management

Chaney, Faccio, and Parsley (2011) exemplify that the earnings quality reported by politically connected firms is significantly poorer than that of similar non-politically connected firms, and amongst the politically connected firms, those that have stronger (ruling party) political connections have the poorest earnings quality. This is because; politically connected firms through ruling party obtain more benefits compared to politically connected firms through opposition party. Therefore, it is argued that in order to hide political benefits, politically connected firms through ruling party are more involved in accruals earnings management in comparison with politically connected firms through opposition party. However, our finding shows the inconsistent result.

H4: Political connections through ruling political party firm are more engaged in accruals earnings management compared to political connections through opposition political party firm.

3.2.5 Ruling/Opposition Party(s) Political Connections and Real Earnings Management

Prior studies exemplify that employing real earnings management strategy reduces the risks that managers are taking when they get involved in earnings management

activities (Braam, Nandy, Weitzel, and Lodh, 2015; Zang, 2011; Cohen and Zarowin, 2010). This is because; real earnings management strategy weakens the monitoring ability of regulators, and the likelihood of outside intervention (Braam, Nandy, Weitzel, and Lodh, 2015). Some researchers opine that real earnings management reduces political costs of connected firms, and thus maintains the reputation of politically connected firms. Amongst the connected firms, those that have connections with the ruling party(s) accumulate more political gains (Chaney, Faccio, and Parsley, 2011). Therefore, it is argued that in order to mask the political gains, ruling party politically connected firms may have more incentives to manipulate earnings through real earnings management strategy in comparison with the opposition party politically connected firm. However, our findings are contradictory to our expectations.

H5: Political connections through ruling political party firm are more engaged in real earnings management compared to political connections through opposition political party firm.

3.2.6 Ruling/Opposition Party(s) Political Connections and Earnings Aggressiveness

Previous studies exhibit that ruling party politically connected firms are more involved in accruals earnings management and report less transparent earnings information compared to opposition party politically connected firms (Chaney, Faccio, and Parsley, 2011). Some researchers argued that firms that involved more in accruals earnings management activities contain higher level of accruals (Bhattacharya, Daouk, and Welker, 2003). Therefore, it is expected that political connection through ruling party(s)

firm exhibit high earnings aggressiveness in comparison with the political connections through opposition party(s) firm.

H6: Political connections through ruling political party firm are positively related to earnings opacity (earnings aggressiveness) compared to political connections from opposition political party firm.

3.2.7 Substitution of Real Earnings Management Strategy for Accruals Earnings Management

Recently, some authors argue that politically connected firms substitute real earnings management for accruals earnings management with the objective to avoid detection by the authorities (Braam, Nandy, Weitzel, and Lodh, 2015). Detection of earnings management may damage the reputation of the firm and its managers, as well as the social image of a connected politician or political party. For these reasons, accrual-based earnings management may be more costly than real earnings management for firms with political connections, if earnings management is risky (Zang, 2011; Cohen and Zarowin, 2010; Cohen, Dey, and Lys, 2008). Substitution of real activities manipulation for accruals earnings management reduces political costs of connected firms, maintains the reputation of politically connected firms, weakens the monitoring ability of society, and the likelihood of outside intervention (Braam, Nandy, Weitzel, and Lodh, 2015; Li, Griffin, Yue, and Zhao, 2013; Kothari, Mizik, and Roychowdhury, 2012). In addition, the substitution of real earnings management for accruals earnings management reduces the risks that managers are taking when they involve in earnings

management (Cohen and Zarowin, 2010; Cohen, Dey, and Lys, 2008; Roychowdhury, 2006).

Braam, Nandy, Weitzel, and Lodh (2015) using multiple-countries data found that politically connected firms substitute real earnings management strategy for accruals earnings management. Following Braam, Nandy, Weitzel, and Lodh (2015) current study also expects that politically influenced firms are likely to substitute real earnings management for accruals earnings management.

H7: Politically influenced firms substitute real earnings management for accruals earnings management compared to non-politically influenced firms.

3.3 Measurement of Variables

3.3.1 Accruals Quality

This study uses a cross-sectional accruals quality model, where the estimate of the model for every industry is classified each year. The empirical measure of accruals quality used in this study is derived from McNichols (2002), which was first introduced by Dechow and Dichev (2002). The Dechow and Dichev (2002) model relates current accruals to lagged, current and one-year ahead cash flows from operations. McNichols (2002) argues that changes in sales and property, plant, and equipment (PPandE) are also the important factors in the estimation of current accruals. So, the author modified the Dechow and Dichev (2002) model by including the change in sales and PPandE in the regression. The McNichols (2002) model significantly reduced the measurement errors and enhanced the explanatory power of the Dechow and Dichev (2002) model.

Based on the McNichols (2002) model, the following equation is used to estimate abnormal accruals:

$$TCA_{j,t} = \partial_0 + \partial_1 CFO_{j,t-1} + \partial_2 CFO_{j,t} + \partial_3 CFO_{j,t+1} + \partial_4 \Delta REV_{j,t} + \partial_5 PPE_{j,t} + \varepsilon_{j,t} \quad (1)$$

Where:

$TCA_{j,t}$ = firm j's total current accruals in year t;

TCA $= \Delta CA - \Delta CL - \Delta Cash + \Delta STDEBT + \Delta TP;$

$CFO_{j,t}$ = firm j's cash flow from operations at year t; cash flow from operations is calculated as net income before extraordinary items less total accruals (TA);

TA $= \Delta CA - \Delta CL - \Delta Cash + \Delta STDEBT + \Delta TP - Dep$

CFO_{t-1} = cash flow from operations at year t-1;

CFO_{t+1} = cash flow from operations at year t+1;

$\Delta REV_{j,t}$ = firm j's change in sales revenue between year t-1 and year t;

$PPE_{j,t}$ = firm j's property, plant and equipment in year t;

$\Delta CA_{j,t}$ = firm j's change in current assets between year t-1 and year t;

$\Delta CL_{j,t}$ = firm j's change in current liabilities between year t-1 and year t;

$\Delta Cash_{j,t}$ = firm j's change in cash between year t-1 and year t;

$\Delta STDEBT_{j,t}$ = firm j's change in debt in current liabilities between year t-1 and year t;

$\Delta TP_{j,t}$ = firm j's change in tax payable between year t-1 and year t;

$Dep_{j,t}$ = firm j's depreciation and amortization expense in year t;

All variables are scaled by lagged total assets.

Equation 1 was then used to estimate the residuals for every industry in each year. Consistent with Sadiq and Othman (2017); Al-dhamari and Ismail (2015), the absolute values of the residuals, capturing accruals quality (accrual-based earnings management) in year t, serve as the proxy for earnings quality.

This study repeated analysis by using three alternative measure of accruals earnings management models, 1) measure based on the signed values (instead absolute values) of the residuals obtained from the main model; 2) measure based on the residuals obtained from the original (unmodified) model of Dechow and Dichev (2002); 3) measure based on the absolute values of the residuals obtained from modified Jones model of Dechow (1995). The current study findings use these alternate measures of accruals which are largely similar to those reported in the main results.

3.3.2 Real earnings management

This study relies upon previous studies to develop proxies for real earnings management. For example, Chi, Liao, and Chen (2016); Braam, Nandy, Weitzel, and Lodh (2015); Zang (2011) examine the following real earnings management activities: reducing the cost of goods sold (COGS) by overproducing inventory to increase

earnings, and cutting discretionary expenditures, including advertising, selling, general, and administrative (SG&A) expenditures, and research and development. The former is measured by the abnormal level of production costs, the latter by the abnormal level of discretionary expenditures. Following studies using the same proxies (Braam, Nandy, Weitzel, and Lodh, 2015; Zang, 2011; Cohen and Zarowin, 2010) give evidence that these measures capture real earnings management.

Managers increase production unnecessarily in order to increase earnings by reporting lower cost of goods sold through increased production. Since the increased production units force managers to spread the fixed overhead costs over a larger number of units, a lower fixed cost per unit reduces cost of goods sold (*COGS*). However, producing more units will also result in high holding costs that will lead to lower cash flows from operations given sales levels and higher annual production costs relative to sales.

A reduced discretionary expenditure also boosts current period earnings at the risk of lower future sales and earnings (Chi, Liao, and Chen, 2016; Braam, Nandy, Weitzel, and Lodh, 2015; Cohen, Dey, and Lys, 2008), and leads to higher current period cash flows (at the risk of lower future cash flows) if the firm generally pays for such expenses in cash (Zang, 2011).

Roychowdhury (2006) estimates the normal level of production costs using the following equation:

$$\frac{PROD_t}{A_{t-1}} = \beta_0 + \beta_1(\frac{1}{A_{t-1}}) + \beta_2(\frac{S_t}{A_{t-1}}) + \beta_3(\frac{\Delta S_t}{A_{t-1}}) + \beta_4(\frac{\Delta S_{t-1}}{A_{t-1}}) + \varepsilon_t \quad (2)$$

Where;

$PROD_t$ = sum of the cost of goods sold (COGS) in year t and the change in inventory from t-1 to t;

A_{t-1} = total assets in year t-1;

S_t = net sales in year t;

ΔS_t = change in net sales from year t-1 to t.

The abnormal level of production costs REM_{PROD} is measured as the estimated residual from the above equation. The higher the residual, the larger is the amount of inventory overproduction, and the greater is the increase in reported earnings through a reduction in the cost of goods sold.

To estimate the normal level of discretionary expenses (DISX), Roychowdhury (2006) runs the following regression:

$$\frac{DISX_t}{A_{t-1}} = \beta_0 + \beta_1(\frac{1}{A_{t-1}}) + \beta_2(\frac{\Delta S_t}{A_{t-1}}) + \beta_3(\frac{S_t}{A_{t-1}}) + \varepsilon_t \quad (3)$$

Where;

$DISX_t$ = discretionary expense at year t,

$DISX_t$ = sum of selling, general, and administrative expenses (SG&A), and research and development (R&D) expenses;

A_{t-1} = total assets in year t-1;

S_{t-1} = net sales in year t-1.

The abnormal level of discretionary expenses (REM_{DISX}) is measured as the estimated residual from the above equation. Low negative residuals signify that firms cut amounts of discretionary expenses to increase reported earnings in the current period. For both proxies, higher residuals correspond with high levels of real activities' manipulation.

Firms that involve in real earnings management (REM) exhibit at least one or both of the following characteristics: abnormally high production costs, and abnormally low discretionary expenses. To capture the aggregate effects of REM, we combine the residuals of both individual measures REM (REM_PROD and REM_DISX) to compute comprehensive metrics of REM. Consistent with Chi, Liao, and Chen (2016); Braam, Nandy, Weitzel, and Lodh (2015); Zang (2011); for our measure, we added the standardized variable of abnormal discretionary expenses (REM_DISX) to the standardized variable of abnormal production costs (REM_PROD) and multiplied by negative one. The higher the amount of this measure (REM_DP), the more likely the firm is involved in cutting discretionary expenses and production manipulation.

3.3.3 Earnings aggressiveness

Earnings closer to cash flows are considered to be of higher quality because it contains comparatively small amount of accruals, (Visvanathan, 2006). Consistent with prior studies such as Sadiq and Othman (2017); Bhattacharya, Daouk, and Welker (2003); Leuz, Nanda, and Wysocki (2003), current study computes total accruals from statement of financial position and statement of comprehensive income statement. Following Bhattacharya, Daouk, and Welker (2003) current study measures earnings aggressiveness as the magnitude of accruals:

$$ACC_{kt} = (\Delta CA_{kt} - \Delta CL_{kt} - \Delta CASH_{kt} + \Delta STD_{kt} - DEP_{kt} + \Delta TP_{kt}) / TA_{kt-1} \quad (4)$$

If any of the above value is missing, following Bhattacharya, Daouk, and Welker (2003) current study will assume that to be zero.

Where;

ACC_{kt} = Total accruals of firm k in year t

ΔCA_{kt} = Change in current assets of firm k in year t

ΔCL_{kt} = Change in current liabilities of firm k in year t

$\Delta CASH_{kt}$ = Change in cash of firm k in year t

ΔSTD_{kt} = Change in long-term debt included in total current liabilities for firm k in year t

DEP_{kt} = Amortization and Depreciation expenses of firm k in year t

ΔTP_{kt} = Change in tax payables of firm k in year t

TA_{kt-1} = Total assets of firm k in year t-1.

3.3.4 Control Variables

To test the relation between political influences and earnings quality (EQ), EQ is regressed on the political influences indicator variable (PI) and control variables. Prior studies (Al-dhamari and Ismail, 2015; Chaney, Faccio, and Parsley, 2011; Mashayekhi and Bazaz, 2010; Cheng and Warfield, 2005; Reynolds and Francis, 2000) show that firm size (SIZE), profitability (ROA), financial leverage (LEV), growth opportunities (GROWTH), net loss (LOSS) and audit quality (BIG4) affect earnings quality. SIZE is represented by the natural logarithm of total assets. A negative coefficient estimate of SIZE means that firm size is positively related to earnings quality.

In addition, Jaggi, Leung, and Gul (2009) found that firms with good operating performance report high earnings quality; and therefore earnings quality is high as profitability or ROA increases. A positive (negative) coefficient estimate of ROA means that firm is negatively (positively) related to earnings quality. DeAngelo (1994) reveals that earnings quality becomes low as the probability of default in debts increases. And thus a positive (negative) coefficient estimate of LEV means that firm is negatively (positively) related to earnings quality. LEV is measured as total liabilities divided by total assets. Moreover, GROWTH is expected to be positively related to lower earnings quality (Lee, Li, and Yue, 2006). A positive coefficient estimate of GROWTH means that firm is negatively related to earnings quality and vice versa. The

current study measures GROWTH as the change in sales revenue from the previous year divided by sales revenue in the previous year.

Moreover, Gul and Lai (2002) argues that firms are perceived to disclose high earnings quality when their financial statements are audited by BIG4 auditors. Thus, a negative coefficient estimate of BIG4 implies that a firm is positively related to earnings quality and vice versa. BIG4 is represented by an indicator variable taking the value of 1 if a firm is audited by one of the Big Four auditing firms and zero if otherwise. Further, a positive coefficient estimate of LOSS means that firm is negatively related to earnings quality and positive otherwise. LOSS is represented by an indicator variable taking the value of 1 if a firm reports LOSS and zero if otherwise.

Table 3.1
Variables Definition

Variable	Definition	Measurement
AEM	Accruals quality	Residuals of a regression of current accruals on previous period, current period, and future cash flows from operation, change in revenue, and property, plant, and equipment using modified Dechow and Dichev model (Francis et al., 2005; McNichols, 2002). Finally the residuals are transformed through absolute value of residuals.
REM_PROD	Real earnings management through over-productions of goods	Residuals of a regression of abnormal production costs, where production costs are defined as the sum of the cost of goods sold (COGS) and the change in inventories (Roychowdhury, 2006). Following Braam, Nandy, Weitzel, and Lodh (2015), the residuals are then multiple by (-1).
REM_DISX	Real earnings management through reducing discretionary expenditures	Residuals of a regression of abnormal discretionary expenses, where discretionary expenses are the sum of R&D expenses and SG&A expenses (Roychowdhury, 2006). Following Braam, Nandy, Weitzel, and Lodh (2015), the residuals are then multiple by (-1).

Table 3.1 (Continued)

Variable	Definition	Measurement
REM	Real earnings management activities through PROD and DISX.	Comprehensive metric of real activities' manipulation, computed as the sum of the standardized variable of RM_PROD and the standardized variable of RM_DISX multiplied by negative one (Braam, Nandy, Weitzel, and Lodh, 2015; Zang, 2011).
EA	Earnings aggressiveness (Transparency)	Earnings aggressiveness metric using earnings opacity model (Bhattacharya, Daouk, and Welker, 2003)
PI	Aggregate measure of political influences using three proxies (1-presence of politician(s) or close relative(s) of politician(s) on board of directors or senior management; 2- firm significantly owned by government; 3- presence of former/current civil/military bureaucrat(s) on board of directors or senior management.	Dummy variable that takes the value of 1 if a firm is politically influenced through any of the mentioned criteria and 0 otherwise (Cheema, Munir, and Su, 2016; Chaney, Faccio, and Parsley, 2011; Bushman and Piotroski, 2006).
PC	Presence of politician(s) or close relative(s) of politician(s) on board of directors or senior management,	A dummy variable that takes the value of 1 if a firm is politically connected and 0 otherwise. There are about 37 out of 64 PI firms which are PI through presence of politicians or their close relatives. (37*5= 185). Among these 37 firms, approx 55% are ruling and 45% is opposition.
GOVT	Firm significantly owned by government at least 10%.	Dummy variable that takes the value of 1 if a firm is significantly owned by government and 0 otherwise.
BUR	Presence of former/current civil/military bureaucrat(s) on board of directors or senior management	Dummy variable that takes the value of 1 in presence of bureaucrat(s) on board of directors, and 0 otherwise.
PCR	It is extracted from PC i.e. political connected firms through ruling and opposition party	Dummy variable that takes the value of 1 if a firm is politically connected through ruling party and 0 if firm is politically connected through opposition party.

Table 3.1 (Continued)

Variable	Definition	Measurement
DPC	Presence of politician(s) on board of directors or senior management	Dummy variable that takes the value of 1 if a firm is politically connected through direct connections i.e. in presence of politician(s) and 0 if firm is politically connected through indirect connections i.e. through close relative(s) of politician(s).
SIZE	Size	Natural log of firms' total assets.
ROA	Return on assets	Percentage of net income divided by total assets.
LEV	Leverage	LEV represents leverage of firm, which is measured by total liabilities divided by total assets.
GROWTH	Growth	It represents the growth in sales, measured by difference between current year and previous year sales divided by previous year sales.
BIG4	Big four auditors	BIG4 is a dummy variable for audit quality, which takes the value of 1 if a firm is audited by BIG4 auditors and 0 otherwise.
LOSS	Net loss	LOSS represents net loss of firm, a dummy variable which takes the value of 1 if a firm is reporting net loss and 0 otherwise.
INDUSTRY	Industry dummies	Firms belonging to the textile sector, manufacturing (excluding textile, consumer goods and cement) sector, consumer goods, fuel and energy, services sector, and cement.

3.3.5 Political Influences

Political influences are generally not reported publicly, that is why defining firms as a politically influenced firm is a difficult proposition. Similarly, identifying politically influenced firm in a developing country like Pakistan is complicated. Prior researchers have adopted three approaches in seeking to identify firms as being politically influenced.

In the first approach, prior studies have employed measures to identify the firm's political connections. Fisman (2001) for example, uses Suharto Dependency Index to measure the political connections amongst Indonesian firms. The index includes the numerical rating (1 to 5) concerning the extent to which each of the industrial groups is dependent on political connections for its profitability. Fisman (2001) takes this measure to identify firms' political connections. In the context of Pakistan, there is a large economic consulting service (www.export.gov) available for foreign firms to identify a potential local trade partner in Pakistan. Although their services include useful information on Pakistani firms regarding their financial conditions, business activities, trading experience and credit-worthiness, but information on firm political connections is unavailable.

In the second approach, prior studies such as Jayachandran (2006); Roberts (1990) identify politically influenced firms through political donations. But public information on such political donations is made publicly available in only few countries. In the context of Pakistan, there is no such public information available on political donations. Therefore, current research is not applicable for identifying political influences through political donations because such information is not available publicly in Pakistan.

In the third approach, prior research matches two different databases to identify firms' political connections. Khwaja and Mian (2005) also adopted this method to recognize politically influenced firms in Pakistan. In doing so, the names of politicians from the first database (such as political parties website, election commission etc.) containing the

politician's information are used to cross-check the senior managers or board of directors (BOD) of firms from the second database (containing firm level information). If a firms' senior management or BOD name is matched to a politicians' name, the firm is considered as politically influenced firm.

Similarly, Faccio (2006) defines a firm as politically influenced in three ways: firstly, if one of the firm's board of directors or large shareholder is a member of parliament; secondly, large shareholders or one of the senior managers is closely related to top officials; and third, one of the senior managers or large shareholders has links with a minister or head of state. The large shareholder is defined as anyone who directly or indirectly owns at least 10% of the voting rights. In the above classifications, firms are recognized as being politically influenced if any relative (such as parents, children, siblings or spouse) of a politician is a large shareholder. The political connections of a second type occur when a senior manager or large shareholder is a friend of the prime minister, minister or a Member of Parliament or assembly. This method is adopted by several other studies such as (Asquer and Calderoni, 2011; Infante and Piaza, 2010; Goldman, Rocholl, and So, 2009; Ferguson and Voth 2008; Leuz and Oberholzer-Gee, 2006; Khwaja and Mian, 2005). These studies generally identify a firm as being connected if any of the firm's Board members has taken part in any level of national elections.

In addition, Bushman, Piotroski, and Smith (2004) define firm as politically influenced when government owns significant shareholding in a firm. Moreover, prior research

such as Cheema, Munir, and Su, 2016; Narayanaswamy (2013); Fan, Wong, and Zhang (2007) consider a firm as politically influenced if one of the senior management is current/former civil/military bureaucrat(s).

3.3.5.1 Types of Political Influences

The current study uses three types of political influences. The first type follows the measurement identified by Cheema, Munir, and Su (2016); Faccio (2006). The authors classified a firm as politically influenced when there is a presence of politician(s) or close relative(s) (friends and family) of politician(s) on the board of directors; one of the shareholders (control at least 10 percent of votes) or senior managers (such as President, Vice-President, Chairman, CEO or Secretary) are a member of provincial assembly or parliament, a head of state or a minister. To suit the Pakistani environment, the second type of political influence is the percentage of government ownership in a firm; this type was identified by Bushman, Piotroski, and Smith (2004). The third type in the current study is consistent with Cheema, Munir, and Su (2016); Narayanaswamy (2013); Fan, Wong, and Zhang (2007) who consider a firm as politically influenced if one of the senior management or board members is a current/former civil/military bureaucrat.

Khwaja and Mian (2005) define politician as a person who holds a position at federal or provincial level, or who had previously/currently holding a position in any political party at federal or provincial level. In order to identify politically influenced firms, the following procedures are carried out:

1) A politician's full name should exactly match with the name of firm's board members name, or the name of a member of senior management or one of the large shareholders.
2) Review of the list of parliament or assembly members at provincial and federal levels.
3) Review of the list of committee members of each political party on its website.
4) Follow the book of Rehman (2006) who identified the list of politically influenced firms in Pakistan.
5) Review the list of firms having government's significant shareholding.
6) Review the website of firms that have current/former civil/military bureaucrat(s) in board of directors or senior management.

Table 3.2
Types of Political Influences used in Previous Studies

Authors	Country	Types
Chi, Liao, and Chen (2016)	China	• Politically connected CEOs • Significant government ownership
Cheema, Munir, and Su (2016)	Pakistan	• A senior manager(s) or board member(s) is politician. • Close relatives of politician is board member or senior manager in a firm. • Board member is former/current civil/military bureaucrat.
Zeng, Li, and Hong (2012)	China	• A senior manager (s) is politician. • Board member is former/current bureaucrat.
Al-dhamari and Ismail (2015)	Malaysia	• Senior management or Board member(s) connected to politician.
Ben-Nasr, Boubakri and Cosset, 2015	Multiple-countries	• Government shareholdings.

Table 3.2 (Continued)

Authors	Country	Types
Liu, Saidi, and Bazaz (2014)	China	• Government shareholdings.
Capalbo et al. (2014)	Italy	• Government ownership.
Chaney, Faccio, and Parsley (2011)	Multiple-countries	• If one of firms' board of director is a Member of Parliament. • Large shareholders are closely related to the top official.
Asquer and Calderoni (2011)	Italy	• If one of firms' board of director is a Member of Parliament. • Large shareholders are closely related to the top official. • Large shareholders have connections with a minister or the head of state.
Goldman (2009)	US	• A firm is defined as politically connected if any board member holds a position at any time in the past such as Member of the House of Representatives, Member of Administration, and Senator. Or has been a director of an organization such as OMB, FEMA, or CIA.
Fan, Wong, and Zhang (2007)	China	• A firm is considered as politically connected if current or former bureaucrats (current or former officer of the central or local governments or the military) are board members or senior management of firm.
Jayachandra (2006)	US	• Political donations
Khwaja and Mian (2005)	Pakistan	• Consider firm as politically connected if a firm has a politician on their board of directors. A politician is defined as a person who stood in the provincial or national elections during the sample period.
Faccio (2006)	Cross-country	• If one of firm's board of directors is a Member of Parliament. • Large shareholders have links with a minister or the head of state. Large shareholders are closely related to the top official.
Fisman (2001)	Indonesia	• Suharto Dependency Index (scale 1-5), developed by the Castle group.

3.4 Data collection and sample specification

This section discusses the construction of sample data used in this study. It also describes the data sources, and further presents information related to the guidelines for the sample selection.

3.4.1 Sources of data

In order to conduct this research, three sources of data are used. First, the firm-level of financial information used in this study comes from Pakistan Stock Exchange (PSE) and State Bank of Pakistan (SBP), which provides financial information of over 600 listed financials and non-financials firms. Moreover, the financial statements—income statement, balance sheet, cash flow statement and information regarding the Board members of each firm are also included. To find political influences through politician(s), bureaucrat(s), and significant government shareholding, current study checked shareholdings patterns and board of directors' name of all non-financials listed firms in PSE. Secondly, in order to identify the indirect (close relatives of politicians) politically influenced firms, this study relied upon the book of Rehman (2006), which reports the list of politically influenced groups or firms and their associated firms within the Pakistani market. The similar source for identifying the affiliated groups in Pakistan has also been used in several other studies, such as Saeed, Belghitar, and Clark (2015); Ashraf and Ghani (2005).

Third, in order to measure the firm's political connections, databases on politically influenced people at national and provincial level are required. The political data is taken from Election Commission of Pakistan (ECP), which conducts elections for the Local government, Provincial and National Assemblies. It maintains the comprehensive information on provincial and national elections, including parties' positions, candidates list and electoral outcomes. Cheema, Munir, and Su (2016); Saeed, Belghitar, and Clark (2015); Khwaja and Mian (2005) have used the same method to identify the political connections in the Pakistani market.

3.4.2 Data sample

The sample of current study includes politically influenced and similar non-politically influenced non-financials listed firms of Pakistan Stock Exchange (PSE). The goal of the current study is to empirically investigate the relationship between political influences and earnings quality in Pakistan. The current study has chosen panel data on Pakistani firms ranging between 2009–2013. Additionally, the sample requires 2008 and 2014 data, because one year lagged and one year lead data is required to represent earnings quality attributes. It was necessary to select a long period (5 years) data, because it covers 5 years tenure of elected government.

Secondly, to draw statistically sound estimations for the relationships to be tested in this study, the current study has chosen a long period. Thirdly, earnings management models required minimum five years data to be tested. Therefore, to be included in the sample, each non-financial firm must have a data ranging 2008-2014 and firms with missing

data of these years were removed from the sample. After applying these restrictions on approximately 350 non-financial firms, the final sample included a panel of 129 firms, which included 64 politically influenced firms and 65 similar non-politically influenced firms within same industry was chosen. Thus, current study used panel data that contained information for a 7-year period. Researcher argue that panel data, having blending characteristics of both time-series and cross-sectional data, improves the efficiency of econometric estimates through offering a greater degree of freedom and less collinearity amongst variables (Hsiao, 1985).

The sample thus included all non-financial listed firms from Pakistan for the period 2008–2014. The reason to limit the sample only to non-financial firms is due to the accounting treatment of financial firms (such as insurance companies, banks and investment firms) which is significantly different to the non-financial firms. Moreover, the capital structure of financial firms is significantly influenced by regulatory requirements; thus, it is not appropriate to compare the financial information of financial firms with non-financial firms.

In order to know that firm is politically influenced, firstly, data on all politicians needed to be gathered. For this purpose, this research relied on the Election Commission of Pakistan (ECP). ECP provides information on all individuals who have participated in previous elections—at both national and state level. Given that the sample period covers 2008–2014, there are two relevant national and state elections for this study: general elections held in 2008 and 2013. This politician database included all the information on

the names and party affiliations for all candidates in the elections, including the winner, party affiliation, and the number of votes each received. Each politician was identified uniquely through a combination of first and last name. There were around 210 national and 460 state constituencies in each election, with 6–9 candidates per constituency and a total of over 8,800 candidates participated in elections. Following Faccio (2006); Khwaja and Mian (2005), irrespective of the electoral outcome, all politicians are considered influential individuals who can provide benefits to firms.

Secondly, firm is considered as politically influenced if significant shareholdings are owned by government. Third, firm is considered as politically influenced if current/former bureaucrat or army officer is a senior manager. In these situations the firms are then considered as politically influenced. Therefore, 64 firms are identified as politically influenced firms.

3.5 Diagnostic Test of Panel Data Analysis

Although there are many benefits of employing panel data, the technique has its own limitations. Thus, a diagnostic test must be performed to avoid results bias. The two basic tests are the serial correlation or autocorrelation test and heteroskedasticity test.

3.5.1 Heteroskedasticity

One of the important issues in panel data is Heterogeneity. It has serious implications for the OLS estimator. Although the OLS estimator remains unbiased, the estimated standard error is wrong. Because of this, hypotheses tests cannot be relied on. There are

many ways to check the presence of heteroskedasticity in the model such as, the Glejser test, Park test, the Goldfeld-Quandt test, Spearman's rank correlation test, the White general heteroskedasticity test and the Breusch-Pagan-Godfrey test. Since, this study used a panel data analysis; therefore it is more appropriate to employ the modified Wald test for group wise heteroskedasticity (Greene, 2003). In the presence of a heteroskedasticity issue, a corrective action using the Panel-corrected standard error (PCSE) or White heteroskedasticity-corrected standard errors is more appropriate to employed (Gujarati and Porter 2009; Pong and Whittington 1994).

3.5.2 Autocorrelation

The presence of serial correlation or autocorrelation results in biased standard error and inefficient estimates of the regressions coefficients. Wooldridge test for autocorrelation is the method that is available to detect autocorrelation. This test involves ascertaining the significance of the null hypothesis showing that no idiosyncratic error of the linear panel data model is present. The presence of autocorrelation shows significant F-value. An autocorrelation error can be corrected using generalized least square (GLS); however, if the panel data has more than fifty observations, panel corrected standard error (PCSE) is more appropriate compared to GLS (Gujarati and Porter, 2009).

3.5.3 Multicollinearity

Multicollinearity is not a serious issue in a panel data model, since panel data itself is capable of reducing its effect (Baltagi, Bratberg, and Holmas, 2005). However, we need to ensure that the variables are not highly correlated; which is a common practice as

well. Highly correlated variables lead to bias and unreliable estimates (Gujarati and Porter 2009). To diagnose the presence of multicollinearity, the common diagnostic tests are the Correlation Matrix and Variance Inflation factor (VIF).

3.6 Method of analysis

This study investigates the relationship between political influences (politically connected BOD, significant government ownership, and civil/military bureaucracy in BOD) and earnings quality (accruals earnings management, real earnings management, and earnings aggressiveness). To achieve the objectives, we employ Panel-Corrected Standard Error (PCSE). Several assumptions of multicollinearity, heteroskedasticity, and autocorrelation are tested on panel data, which determined that PCSE technique is the best estimator. Prior studies like Gujarati and Porter (2009); Pong and Whittington (1994) also suggest that if panel data has heteroskedasticity issue, then PCSE is the best estimator. Therefore, PCSE regression method is used to examine the relationship between political influences and earnings quality using multiple proxies.

As discussed previously, this study analyzes earnings quality by accruals quality (accruals earnings management), real earnings management, and earnings aggressiveness. Equation 5 is derived from equation 1 to test hypothesis 1. The following equations were used to test the impact of political influences (using combined aspect i.e. PI) on accruals quality:

$$AEM_{j,t} = \delta_0 + \delta_1 PI_{j,t} + \delta_2 SIZE_{j,t} + \delta_3 ROA_{j,t} + \delta_4 LEV_{j,t} + \delta_5 GROWTH_{j,t} + \delta_6 BIG4_{j,t} + \delta_7 LOSS_{j,t} + \delta_8 INDUSTRY_{j,t} + \omega_{j,t} \quad (5)$$

Where:

$AEM_{j,t}$ = accruals earnings management (accruals quality) of firm j at year t;

$PI_{j,t}$ = dummy variable for politically influenced firms, 1 for politically influenced firms, and 0 otherwise.

$SIZE_{j,t}$ = firm j's natural log of total assets at year t;

$ROA_{j,t}$ = firm j's percentage of net income divided by total assets at year t;

$LEV_{j,t}$ = firm j's leverage at year t, measured by total liabilities divided by total assets;

$GROWTH_{j,t}$ = firm j's growth rate in sales at year t;

$BIG4_{j,t}$ = dummy variable for audit quality, 1 if the auditor is Big Four, and 0 otherwise.

LOSS = dummy variable for net loss at year t, 1 if the firms report loss and 0 otherwise.

The coefficient on PI (δ_1) shows the relationship between political influences and accruals quality. Positive (negative) estimates indicate that political influences are related to lower (higher) accruals quality.

The following equation was derived from equation one to test the impact of political influences (using multiple aspects i.e. PC, GOVT, and BUR) on accruals quality, AEM is regressed on the political influences (i.e. PC, GOVT, and BUR) and control variables.

PC, GOVT, and BUR are dummy variables for politically influenced firm, 1 for politically influenced firms and 0 for non-politically influenced firms:

$$AEM_{j,t} = \delta_0 + \delta_1 PC_{j,t} + \delta_2 GOVT_{j,t} + \delta_3 BUR_{j,t} + \delta_4 SIZE_{j,t} + \delta_5 ROA_{j,t} + \delta_6 LEV_{j,t} + \delta_7 GROWTH_{j,t} + \delta_8 BIG4_{j,t} + \delta_9 LOSS_{j,t} + \delta_{10} INDUSTRY_{j,t} + \omega_{j,t} \quad (6)$$

Where;

All variables are same as above in equation 5;

PC = Political connections through politician(s) or close relative(s) of politician(s), 1 for politically connected firms, and 0 otherwise;

GOVT = Government owned firms, 1 for significantly government own firms and 0 otherwise;

BUR = Presence of bureaucrat(s) on BOD, 1 for presence of bureaucrat(s) and 0 otherwise.

The coefficient on PC (δ_1), GOVT (δ_2), and BUR (δ_3) shows the relationship between political influences proxies and accruals quality. Positive (negative) estimates indicate that political influences are related to lower (higher) accruals quality.

Equation 7 is derived from equation two and three to test hypothesis 2. The following equations were used to test the relationship between political influences (using combined aspect i.e. PI) and real earnings management. REM is regressed on the political influences (i.e. PI) and control variables. PI is a dummy variable for politically

influenced firm, 1 for politically influenced firms and 0 for non-politically influenced firms:

$$REM_{j,t} = \delta_0 + \delta_1 PI_{j,t} + \delta_2 SIZE_{j,t} + \delta_3 ROA_{j,t} + \delta_4 LEV_{j,t} + \delta_5 GROWTH_{j,t} + \delta_6 BIG4_{j,t} + \delta_7 LOSS_{j,t} + \delta_8 INDUSTRY_{j,t} + \omega_{j,t} \quad (7)$$

Where;

All variables are same as above;

REM = Aggregate measure of real earnings management.

The following equation was derived from equation two and three to test the relationship between political influences (using multiple aspects i.e. PC, GOVT, and BUR) and real earnings management, REM is regressed on the political influences (i.e. PC, GOVT, and BUR) and control variables. PC, GOVT, and BUR are dummy variables for politically influenced firm, 1 for politically influenced firms and 0 for non-politically influenced firms:

$$REM_{j,t} = \delta_0 + \delta_1 PC_{j,t} + \delta_2 GOVT_{j,t} + \delta_3 BUR_{j,t} + \delta_4 SIZE_{j,t} + \delta_5 ROA_{j,t} + \delta_6 LEV_{j,t} + \delta_7 GROWTH_{j,t} + \delta_8 BIG4_{j,t} + \delta_9 LOSS_{j,t} + \delta_{10} INDUSTRY_{j,t} + \omega_{j,t} \quad (8)$$

Where;

All variables are same as above.

Equation 9 is derived from equation four to test hypothesis 3. The following equations were used to test the relationship between political influences (using combined aspect i.e. PI) and earnings aggressiveness (EA). EA is regressed on the political influences (i.e. PI) and control variables. PI is a dummy variable for politically influenced firm, 1 for politically influenced firms and 0 for non-politically influenced firms:

$$EA_{j,t} = \delta_0 + \delta_1 PI_{j,t} + \delta_2 SIZE_{j,t} + \delta_3 ROA_{j,t} + \delta_4 LEV_{j,t} + \delta_5 GROWTH_{j,t} + \delta_6 BIG4_{j,t} + \delta_7 LOSS_{j,t} + \delta_8 INDUSTRY_{j,t} + \omega_{j,t} \quad (9)$$

Where;

All variables are same as above;

EA = EA represents earnings aggressiveness of firm j, in year t.

The following equation was derived from equation four to test the relationship between political influences (using multiple aspects i.e. PC, GOVT, and BUR) and earnings aggressiveness (EA), EA is regressed on the political influences (i.e. PC, GOVT, and BUR) and control variables. PC, GOVT, and BUR are dummy variables for politically influenced firm, 1 for politically influenced firms and 0 for non-politically influenced firms:

$$EA_{j,t} = \delta_0 + \delta_1 PC_{j,t} + \delta_2 GOVT_{j,t} + \delta_3 BUR_{j,t} + \delta_4 SIZE_{j,t} + \delta_5 ROA_{j,t} + \delta_6 LEV_{j,t} + \delta_7 GROWTH_{j,t} + \delta_8 BIG4_{j,t} + \delta_9 LOSS_{j,t} + \delta_{10} INDUSTRY_{j,t} + \omega_{j,t} \quad (10)$$

Where;

All variables are same as above.

Equation 11 is derived from equation 1, to test the relationship between political connections (through ruling or opposition party) and accruals quality, AEM is regressed on the ruling/opposition party political connections (PCR) and control variables. PCR is a dummy variable for the politically connected firm, 1 for political connection through ruling party and 0 for opposition party.

$$AEM_{j,t} = \delta_0 + \delta_1 PCR_{j,t} + \delta_2 SIZE_{j,t} + \delta_3 ROA_{j,t} + \delta_4 LEV_{j,t} + \delta_5 GROWTH_{j,t} + \delta_6 BIG4_{j,t} + \delta_7 LOSS_{j,t} + \delta_8 INDUSTRY_{j,t} + \omega_{j,t} \quad (11)$$

Where;

All variables are same as above;

$PCR_{j,t}$ = dummy variable of political connections; 1 for ruling party and 0 for opposition party.

The coefficient on PCR (δ_1) shows the relationship between ruling/opposition party political connections and accruals earnings management (accruals quality). Positive (negative) estimates indicate that politically connected firms through ruling party are related to lower (higher) accruals quality.

Equation 12 is derived from equation two and three (i.e. the combined measure of real earnings management), to test the relation between political connections (through ruling or opposition party) and real earnings management (REM), REM is regressed on the ruling/opposition party political connections (PCR) and control variables. PCR is a dummy variable for the politically connected firm, 1 for political connection through ruling party and 0 for opposition party.

$$REM_{j,t} = \delta_0 + \delta_1 PCR_{j,t} + \delta_2 SIZE_{j,t} + \delta_3 ROA_{j,t} + \delta_4 LEV_{j,t} + \delta_5 GROWTH_{j,t} + \delta_6 BIG4_{j,t} + \delta_7 LOSS_{j,t} + \delta_8 INDUSTRY_{j,t} + \omega_{j,t} \quad (12)$$

Where;

All variables are same as above;

The coefficient on PCR (δ_1) shows the relationship between ruling/opposition party political connections and real earnings management. Positive (negative) estimates indicate that politically connected firms through ruling party are more (less) involved in real earnings management.

Equation 13 is derived from equation four, to test the relationship between political connections (through ruling or opposition party) and earnings aggressiveness (EA), EA is regressed on the ruling/opposition party political connections (PCR) and control variables. PCR is a dummy variable for the politically connected firm, 1 for political connection through ruling party and 0 for opposition party.

$$EA_{j,t} = \delta_0 + \delta_1 PCR_{j,t} + \delta_2 SIZE_{j,t} + \delta_3 ROA_{j,t} + \delta_4 LEV_{j,t} + \delta_5 GROWTH_{j,t} + \delta_6 BIG4_{j,t} + \delta_7 LOSS_{j,t} + \delta_8 INDUSTRY_{j,t} + \omega_{j,t} \quad (13)$$

Where;

All variables are same as above;

Positive (negative) coefficient for PCR (δ_1) indicates that politically connected firms through ruling party(s) have more (less) aggressive earnings, implies less (high) transparent earnings.

Equation 14 is derived from equation two and three (i.e. the combined measure of real earnings management), to test the relation between the interaction effect of political influences and accruals earnings management (i.e. PIAEM) on real earnings management (REM), REM is regressed on the accruals earnings management (AEM), political influences (PI), the interaction effect of political influences and accruals earnings management (i.e. PIAEM), and control variables. AEM is the residuals extract from equation 1; PI is a dummy variable of the aggregate measure of politically influenced firms, 1 for politically influenced firms and 0 for non-politically influenced firms; PIAEM is the interaction variable of political influences and accruals earnings management'

$$REM_{j,t} = \delta_0 + \delta_1 AEM_{j,t} + \delta_2 PI_{j,t} + \delta_3 PIAEM_{j,t} + \delta_4 SIZE_{j,t} + \delta_5 ROA_{j,t} + \delta_6 LEV_{j,t} + \delta_7 GROWTH_{j,t} + \delta_8 BIG4_{j,t} + \delta_9 LOSS_{j,t} + \delta_{10} INDUSTRY_{j,t} + \omega_{j,t} \quad (14)$$

Where;

All variables are same as above;

$PIAEM_{j,t}$ = interaction effect of political influences and accruals earnings management.

3.7 Conclusion

This chapter has covered the theoretical framework of this study. Three proxies of political influences are used: presence of politician(s) or close relative(s) of politician(s) on firms' board of directors or senior management; firm is significantly owned by government; and presence of current/former civil/military bureaucrat(s) on firms' board of directors or senior management. Their relationship with earnings quality is also depicted in the theoretical framework. Twenty one hypotheses are to be used to reflect the impact of political influences on earnings quality using different proxies of both variables. In addition, this chapter has also discussed the research method to be adopted in the current study. To achieve the research objectives a quantitative research approach is adopted. This chapter also discusses the data collection and data sample procedures to be used in the current study. Moreover, it also deals with model specification or measurement. Lastly, the proposed method to test the hypotheses is also highlighted.

CHAPTER FOUR

DATA ANALYSIS

4.1 Introduction

This chapter presents the study's empirical results. First, this chapter presents the industry classifications, followed by the descriptive statistics and the Pearson correlation matrix for the variables used in the study's regression analysis. Next, the chapter presents different diagnostic tests of panel data analysis, and results from the panel corrected standard error according to the hypotheses outlined in Chapter Three. Lastly, this chapter shows sensitivity analyses and the additional tests results.

4.2 Industry Classification

Our data sample includes 129 listed firms and 645 observations over the 5-year period (2009-2013). In Table 4.1, we can see that the majority number of sample firms are from the textile sector (21.71%), followed by the manufacturing (excluding textile, consumer goods and cement) sector (20.93%), consumer goods (20.16%), fuel and energy (16.28%), services sector (12.40%), and cement (8.53%).

Table 4.1
Industry Classification

Industry	Freq.	Percent	Cum.
Cement	55	8.53	8.53
Consumer goods	130	20.16	28.68

Table 4.1 (Continued)

Industry	Freq.	Percent	Cum.
Fuel and Energy	105	16.28	44.96
Manufacturing	135	20.93	65.89
Services	80	12.4	78.29
Textile	140	21.71	100
Total	645	100	

4.3 Descriptive Statistics

Table 4.2 shows the descriptive statistics of all the variables used in the earnings quality models (i.e. accruals quality model, real earnings management model, earnings aggressiveness, and earnings smoothing model). Table 4.2 shows the standard deviation, mean, minimum, and maximum of the dependent and explanatory variables of the four models.

4.3.1 Dependent Variables

In terms of dependent variables, the values reported in descriptive statistics are the signed values of the dependent values. However, we used absolute value in our main results and signed value in sensitivity analysis. Earnings aggressiveness (EA) score ranged from -1.99332 to 1.984933 with a mean value of -0.0077809, which is closed to the mean value of Bhattacharya, Daouk, and Welker (2003).

Similarly, the accruals earnings management (AEM) score range from -1.92648 to 1.76998 with a mean value of 0.0084, which is closed to the mean value (0.026) reported by Braam, Nandy, Weitzel, and Lodh (2015). Moreover, real earnings management (REM) score range from -2.88629 to 13.17507 with a mean value of 0.0349084, which is close to the mean value of real earnings management model reported by Braam, Nandy, Weitzel, and Lodh (2015).

4.3.2 Independent Variables

Table 4.2 gives the descriptive statistics of the independent variables (political influences proxies) used in the current study. In total, there are 129 firms and 645 observations; where politically influenced firms have 48.83% of the observations and 51.17% of the firms are non-politically influenced. In addition, the percentage of political influence firms (through politician(s) in BOD) was 28.68%, through significant government ownership was 11.62%, while the percentage of politically influenced firms (through civil/military bureaucracy) was 18.91%.

Moreover, to check the difference in effect between ruling party political connections and opposition party political connections, we regressed all three earnings quality attributes (i.e. accruals quality, real earnings management, and earnings aggressiveness) between political connections through ruling party and opposition party. The percentage of ruling party political connection (PCR) was 54.59%, and the percentage of opposition party political connections remained 45.41%.

4.3.3 Control Variables

The mean percentage of the return on assets (ROA) of the firms was 7.80, standard deviation 13.94 with a minimum -49.38 and maximum 61.43 percent, which is closed to the mean value of Harymawan and Nowland (2016). The mean ratio of debt to total assets (Leverage) was 0.6283 with a standard deviation of 0.3146 ranging from 0.0314643 to 3.011882, which is same as the mean value of Harymawan and Nowland (2016). The average logged value of firm size was 6.84, standard deviation 0.67 with a minimum 4.72 and maximum 8.61. In addition, the average firms' growth was 0.16 with a standard deviation of 0.50 ranging from -1.459162 to 7.980104, which is higher than the average firms' growth of Harymawan and Nowland (2016) i.e. 0.04. The mean percentage of loss was 22.17%, implying that 22.17% of firm-years observations are facing losses, with standard deviation being 0.41 ranging from 0 to 1. Moreover, on average, big four audit (BIG4) firms audited 44.34% of the observations, while the remaining 55.64% were audited by non-big four auditors, with a standard deviation of 49.71% ranging from 0 to 1.

Table 4.2
Descriptive Statistics of the earnings quality attributes (i.e. earnings aggressiveness, accruals earnings management, and real earnings management), political influences, and control variables

Variables	Observations	Mean	Standard Deviation	Min	Max
Dependent Variables					
EA	645	-0.0077	0.2199	-1.9933	1.9849
AEM	645	0.0084	0.2564	-1.9264	1.7699
REM	645	0.0349	0.8507	-2.8862	13.175
Independent Variables					
PI	645	0.4883	0.5002	0	1

Table 4.2 (Continued)

Variables	Observations	Mean	Standard Deviation	Min	Max
PC	645	0.2868	0.4526	0	1
GOVT	645	0.1162	0.3208	0	1
BUR	645	0.1891	0.3919	0	1
PCR	185	0.5459	0.4992	0	1
Control Variables					
ROA	645	7.8078	13.9422	-49.38	61.43
LEV	645	0.6283	0.3146	0.0314	3.0118
SIZE	645	6.8403	0.6702	4.7298	8.6169
Growth	645	0.1660	0.5022	-1.4591	7.9801
Loss	645	0.2217	0.4157	0	1
BIG4	645	0.4434	0.4971	0	1

Note: EA represents the earnings aggressiveness, calculated using Bhattacharya et al. (2003) model, AEM is the residuals of accruals earnings management (accruals quality) model, which is calculated using Modified Dechow and Dichev (2002) Model, REM is the aggregate residuals of real earnings management model, PI is the aggregate proxy of political influences, which includes all three characteristics of political influences in a single proxy; indicator value 1 for politically influenced firms and 0 otherwise, PC represents the presence of politicians or close relatives of politicians in board of directors; indicator value 1 for political connections and 0 otherwise, GOVT is the significant government ownership in a firm; indicator value 1 for government owned firms and 0 otherwise, BUR represents the presence of civil/military bureaucrat in board of directors; indicator value 1 for bureaucrats and 0 otherwise, PCR is the ruling party political connections; indicator value 1 for ruling party political connections and 0 opposition party political connections, ROA is the percentage of return on assets, LEV is ratio of debts on total assets, SIZE is the log of total assets, GROWTH is the percentage change in sales, Loss is the net loss of firms; indicator value 1 for firms producing losses and 0 otherwise, BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise.

4.4 Analysis of Pearson Correlation Matrix

Table 4.3 shows the Pearson correlation matrix for dependent variables i.e. accruals earnings management (AEM), real earnings management (REM), and earnings aggressiveness (EA), and explanatory variables i.e. aggregate measure of political influences (PI), multiple aspects of political influences (i.e. PC, GOVT, and BUR), and control variables. The correlation matrix examines the correlation among independent variables and control variables. The political influences (PI) and multiple proxies of PI (i.e. PC, GOVT, and BUR) have a correlation with a positive relationship with AEM (r

= 0.11, p = 0.0025), PC (r = 0.059, p = 0.13), GOVT (r = 0.066, p = 0.09), and BUR (r = 0.07, p = 0.05). The correlation between AEM and independent variables (PI, PC, GOVT, and BUR) indicate the positive relation between them. In addition, BIG4, GROWTH, LEV, and ROA have a correlation with a negative relationship with AEM. These control variables were negatively correlated with AEM i.e. BIG4 (r = -0.06, p = 0.113), GROWTH (r = -0.11, p = 0.004), LEV (r = -0.11, p = 0.004), and ROA (r = -0.02, p = 0.54). This suggests that firms with BIG4 auditors, high growth rate, high leverage and return on assets involve less in AEM. Moreover, Loss and SIZE have a correlation with a positive relationship with AEM. These control variables are positively correlated with AEM i.e. Loss (r = 0.03, p = 0.37), and SIZE (r = 0.04, p = 0.27). Therefore, this could be interpreted that firms with negative earnings and big size are more involved in AEM.

In addition, Table 4.3 shows the Pearson correlation matrix for aggregate measure of real earnings management (REM), political influences and proxies of political influences, and control variables. The political influences (PI) and multiple proxies of PI (i.e. PC, GOVT, and BUR) have a correlation with a positive relationship with REM (r = 0.15, p = 0.0001), PC (r = 0.10, p = 0.01), GOVT (r = 0.05, p = 0.19), and BUR (r = 0.08, p = 0.02). The correlation between REM and independent variables (PI, PC, GOVT, and BUR) indicate the positive relation between them. In addition, BIG4, GROWTH, LEV, and ROA have a correlation with a positive relationship with REM. These control variables were positively correlated with REM i.e. BIG4 (r = 0.04, p = 0.23), GROWTH (r = 0.07, p = 0.07), LEV (r = 0.04, p = 0.21), and ROA (r = 0.208, p

= 0.00). This suggests that firms with BIG4 auditors, high growth rate, high leverage and return on assets involve more in REM. Moreover, Loss and SIZE have a correlation with a negative relationship with REM. These control variables were negatively correlated with REM i.e. Loss (r = -0.098, p = 0.012), and SIZE (r = -0.097, p = 0.013). Therefore, this could be interpreted that firms with negative earnings and big size are less involved in REM.

Moreover, Table 4.3 shows the Pearson correlation matrix for earnings aggressiveness (EA), political influences and proxies of political influences, and control variables. The political influences (PI) and multiple proxies of PI (i.e. PC, GOVT, and BUR) have a correlation with a positive relationship with EA (r = 0.08, p = 0.024), PC (r = 0.05, p = 0.19), GOVT (r = 0.02, p = 0.49), and BUR (r = 0.05, p = 0.18). Additionally, BIG4, Loss, ROA, and SIZE have a correlation with a positive relationship with EA. These control variables were positively correlated with EA i.e. BIG4 (r = 0.017, p = 0.65), Loss (r = 0.002, p = 0.94), ROA (r = 0.007, p = 0.85), and SIZE (r = 0.05, p = 0.17). On the other hand, GROWTH and LEV are negatively correlated with EA i.e. GROWTH (r = -0.09, p = 0.01), and LEV (r = -0.11, p = 0.004). Therefore, this could be argued that high growth and leverage firms are negatively and significantly correlated to earnings aggressiveness.

Table 4.3
Coefficient correlations between Earnings Quality Attributes and Explanatory Variables

	AEM	REM	EA	PI	PC	GOVT	BUR	BIG4	GROWTH	LEV	LOSS	ROA	SIZE
AEM	1												
REM	---	1											
EA	---	---	1										
PI	0.118***	0.15***	0.088**	1									
PC	0.059	0.10**	0.051	0.65***	1								
GOVT	0.067*	0.051	0.027	0.361*	-0.12***	1							
BUR	0.074*	0.088**	0.051	0.486***	-0.21***	0.442***	1						
BIG4	-0.062	0.046	0.017	-0.041	-0.28***	0.211***	0.31***	1					
GROWTH	-0.11***	0.07*	-0.10**	-0.019	-0.026	0.022	0.005	0.008	1				
LEV	-0.11***	0.049	-0.11***	0.177***	0.267***	-0.018	-0.12***	-0.31***	-0.025	1			
LOSS	0.034	-0.01**	0.002	0.12*	0.173*	-0.053	-0.124*	-0.258*	-0.0913**	0.3486*	1		
ROA	-0.024	0.208*	0.007	-0.063	-0.214*	0.073***	0.216*	0.376*	0.12*	-0.41*	-0.63*	1	
SIZE	0.043	-0.01**	0.053	0.177*	-0.132*	0.449*	0.371*	0.482*	-0.0032	-0.116*	-0.07*	0.0441	1

4.5 Diagnostic Test Results

This study has done the diagnostic tests for the presence of a number of econometrics issues related to panel data. As explained earlier in Chapter 4, panel data model assumes that the disturbance terms have homoscedastic variances and constant serial correlations through random individual effects (Baltagi 2005). The next section presents the diagnostic tests results of the residuals of the panel regression model.

4.5.1 Heteroskedasticity Results

In current study, the assumption is that the disturbance terms of the variables should be constant across the panel. Panel data assumes that the regression disturbances are homoscedastic with the same variance across time and individuals (Baltagi, 2005). To diagnose heteroskedasticity in our models, we run the Wald test for groupwise heteroskedasticity, in order to check the presence of heteroskedasticity in residuals. The fixed effects regressions were performed on three earnings quality attribute (i.e. accruals quality, earnings aggressiveness, and real earnings management). The accruals quality attribute resulted in Chi-Square (129) = 68209.29, earnings aggressiveness resulted in Chi-Square (129) = 2.1e+05, and real earnings management resulted in Chi-Square (129) = 6.1e+05, all three attributes were significant at 0.0000 level. Therefore, the results signified the presence of heteroskedasticity in all three earnings quality attributes, and robust standard errors (panel corrected standard error) technique is adopted to solve the heteroskedasticity issue.

Normality test was not conducted because under panel data analysis normality and linearity were not a major concerns because the standard least squares assumption was not applicable in panel data (Gujarati and Porter, 2004) and most of the study's continuous variables were transformed (Turpen, 1990). In addition, outliers test was not conducted because this study adopted robust regression techniques, which handle the outliers and fit the outliers (Gujarati and Porter, 2004). In addition, outliers could also be notice through descriptive statistics of the variables, and thus looking at the descriptive statistics in Table 4.2, it does not show any extreme high and low values.

4.5.2 Autocorrelation Results

The current study employed the Wooldridge test for autocorrelation or serial correlation in STATA using the xtserial command to check the serial correlation in panel data. The null hypothesis assumed no first order serial correlation. For the earnings aggressiveness attribute, the test of serial correlation resulted in F (1, 128) = 0.374, for the accruals quality attribute F (1, 128) = 0.417, and for real earnings management attribute F (1, 128) = 3.419. Earnings aggressiveness, accruals quality, and real earnings management attributes were insignificant at 0.5418, 0.5194, and 0.0667 levels respectively.

Based on the results, we accept the null hypothesis of no serial correlation between error terms in earnings aggressiveness, accruals quality, and real earnings management attributes. The results suggest the absence of first order autocorrelation in the earnings aggressiveness, accruals quality, and real earnings management attributes.

4.5.3 Multicollinearity Results

Tables 4.3 shows the results of the multicollinearity test between the variables. Even though, multicollinearity is not a serious threat for panel data (Baltagi 2005). We further examined the nature of the panel data analysis; the correlation coefficient between independent variables was also computed. Multicollinearity existed between variables when the correlation between variables is more than 0.7 (Hair et al., 2010). In addition, Gujarati and Porter (2009) suggested that more than 0.80 is a sign of serious correlation. As shown in the correlation coefficient tables, multicollinearity was not a serious threat to this study, since all the variables fell within the acceptable range.

Table 4.4
VIF results of political influences (using multiple proxies) and control variables

Variable	VIF	1/VIF
PC	1.16	0.861823
GOVT	1.42	0.702099
BUR	1.39	0.716937
LOSS	1.71	0.584445
SIZE	1.66	0.602563
BIG4	1.66	0.6038
LEV	1.31	0.763015
ROA	2.04	0.490727
GROWTH	1.02	0.980306
Mean VIF	1.49	

Note: PC represents the presence of politicians or close relatives of politicians in board of directors; indicator value 1 for political connections and 0 otherwise, GOVT is the significant government ownership in a firm; indicator value 1 for government owned firms and 0 otherwise, BUR represents the presence of civil/military bureaucrat in board of directors; indicator value 1 for bureaucrats and 0 otherwise, ROA is the percentage of return on assets, LEV is ratio of debts on total assets, SIZE is the log of total assets, GROWTH is the percentage change in sales, LOSS is the net loss of firms; indicator value

1 for firms producing losses and 0 otherwise, BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise.

In addition, we performed the Variance Inflation Factor (VIF) test, to further test the presence of multicollinearity among explanatory variables. The tables below show that the VIF did not exceed 10, since it fell below the threshold of 10 suggested in Kennedy (1992). Therefore, multicollinearity was not a serious threat.

4.6 Measurements of Relationships

In order to examine the research questions, seven hypotheses were tested using ten regressions in order to use inferential statistic. Hypothesis 1 to 3 was used to answer the research question one. Hypotheses 1, investigated the relationship between political influences (as a single aspect and multiple aspects) and accruals earnings management (accruals quality). Hypotheses 2, tested the relationship between political influences (as a single aspect and multiple aspects) and real earnings management. In addition, hypothesis 3 tested the relationship between political influences (as a single aspect and multiple aspects) and earnings opacity (earnings aggressiveness).

Furthermore, hypotheses 4 to 6 were used to answer the research question two. Hypothesis 4 tested the relationship between political connections (ruling/opposition political party) and accruals earnings management (accruals quality). While hypothesis 5 tested the relationship between political connections through ruling/opposition political party connected firm and real earnings management. In addition, hypothesis 6

tested the relationship between political connections through ruling/opposition political party connected firm and earnings opacity (earnings aggressiveness).

Additionally, hypothesis 7 was used to answer the research question three. Hypothesis 7 was used to test whether politically influenced firms substituted real earnings management for accruals earnings management. Following Braam, Nandy, Weitzel, and Lodh (2015), hypothesis 7 tested the interacting effect of political influences and accruals earnings management on real earnings management. The research hypotheses tested are presented below:

4.7 Panel Regression Results for Earnings Quality Attributes

As discussed earlier in chapter three, ten regressions were estimated to test various hypotheses of this study. Consistent with the explanations given in previous chapter (Section 3.7), panel corrected standard errors (PCSE) estimation techniques were employed to test all three earnings quality attributes. Prior studies (Gujarati, 2009 and Petersen, 2009), stated that in presence of heteroskedasticity, PCSE and generalized least square (GLS) are the best estimators and provide robust results. The Modified Wald test for groupwise heteroskedasticity in fixed effect regression model showed (P>Chi-Square = 0.0000) for all three attributes, implies that all models have heteroskedasticity issue. Therefore, to overcome heteroskedasticity issue, GLS or PCSE techniques are more appropriate. However, PCSE technique gives more robust results compared to GLS. Therefore, PCSE technique is employed to test our hypothesis.

4.7.1 Relationship between Political Influences (combined proxy and multiple proxies) and Accruals Earnings Management (Accruals Quality)

The R-Square for model 1 and 2 was 0.1577 and 0.1605 respectively. The low R-Square is consistent with previous studies. For example, Asthana and Boone (2012); Choi, Kim, and Zang (2010) report 0.20 and 0.148 respectively. Table 4.5 shows the results of relationship between political influences (using combined aspect) and accruals quality. In addition, model 2 in Table 4.5 presents the results of relationship between political influences (using multiple aspects) and accruals quality.

Results of H1

The result shows that politically influenced firms are positively and significantly related to accruals earnings management and have lower accruals quality, which implies that the quality of earnings are lower amongst politically influenced firms. The coefficient for the political influences (using combined aspect) was positive and significant 0.03196 (z = 3.99) using panel corrected standard error (PCSE) technique. This result is consistent with the findings of studies by Al-dhamari and Ismail (2015); Guo and Ma (2015); and Narayanaswamy (2013), who relates political influences with lower earnings quality (accruals quality). Therefore, the results suggest that the presence of politically influenced people in board of directors (BOD) or management and significant government ownership increase accruals earnings management activities. Thus, this finding supports hypothesis 1.

Model 2 of Table 4.5, shows that political influences (through politically connected (PC) BOD) are significantly and positively related to accruals earnings management and have lower accruals quality, which means that politically connected firms have lower earnings quality. The coefficient for the political connections is significant and positive 0.0231 (z = 3.11) using (PCSE) technique. This finding is in line with the results of studies by Al-dhamari and Ismail (2015); Li et al. (2013); and Chaney, Faccio, and Parsley (2011), who relate political connections with accruals earnings management (accruals qulity). Hence, the results suggest that the presence of politician(s) in (BOD) or management increase accruals earnings management activities and lower accruals quality.

In addition, the positive and significant relationship between political influences (through significant government ownership) and accruals earnings management supports the view that political influences in terms of the significant government ownership is related to lower accruals quality. The coefficient for the government ownership is significant and positive 0.0465 (z = 2.28) using (PCSE) technique. This finding is consistent with the findings of studies by Ben-Nasr et al. (2015); Capalbo et al. (2014); Zeng, Li, and Hong (2012); and Li et al. (2011), who relate government or state ownership with lower accruals quality and high accruals earnings management activities. Thus, the findings suggest that firms with significant government ownership are more involved in accruals earnings management, implies lower accruals quality. Therefore, this finding supports hypothesis 1.

Moreover, the results show that accruals quality is poor amongst firms with political influences (through civil/military bureaucracy). The coefficient for the presence of bureaucrat in firms' BOD was significant and positive 0.0211 (z = 1.8). Narayanaswamy (2013) and Zeng, Li, and Hong (2012) also found a positive relationship between political influences (through civil/military bureaucracy) and accruals earnings management; it means firms with bureaucrats in the BOD have lower accruals quality. Hence, the findings suggest that firms with the presence of civil/milatary bureaucrat(s) on the BOD are more involved in accruals earnings management and have lower earnings quality (accruals quality). Thus, this finding supports hypothesis 1.

Results for Control Variables

We included seven control variables in our models, which represented the financial attributes of the firms. In addition, we included industry dummies to control for sector-specific effects. Consistent with previous studies, we included as firm control variables leverage (LEV), return on assets (ROA), total assets (SIZE), BIG4 auditors, GROWTH, and LOSS (Al-dhamari and Ismail, 2015; Braam, Nandy, Weitzel, and Lodh, 2015; Zang, 2012; Chaney, Faccio, and Parsley, 2011; Cohen, Dey, and Lys, 2008).

Table 4.5, shows the relationship between accruals earnings management and control variables. Seven control variables were included in accruals earnings management (accruals quality) model, which represented the financial attributes of the firms. Consistent with previous studies such as Dimitropoulos and Asteriou (2010); Epps and

Ismail (2009); and Sivaramakrishnan and Yu (2008), in model 1, the coefficient for firm size was positive and significant 0.0285535 (z = 1.32). However, in model 2, the coefficient for firm size was positive but not significant 0.0235668 (z = 1.01). Moreover, loss was positively related to accruals earnings management in both models. The coefficient for loss in model 1 and 2 was positive but not significant 0.0198 (z = 1.1) and 0.0215 (z = 1.2) respectively.

In addition, consistent with prior studies (i.e. Chaney, Faccio, and Parsley, 2011; and Cheng and Warfield, 2005), BIG4 auditors were negatively and significantly related to accruals earnings management. It is argued that firms audited by top big four audit firms are less involved in accruals earnings management activities compared to firms audited by non-big four audit firms. In model 1, the coefficient for BIG4 was negative and significant -0.0314674 (z = -1.98). Moreover, in model 2, the coefficient for BIG4 was negative and significant -0.0308565 (z = -1.84).

Furthermore, consistent with the study of Gul, Fung, and Jaggi (2009), return on assets (ROA) was negatively and significantly related to accruals earnings management, it implies that politically influenced firms employ accruals earnings management strategy in order to report poor organizational performance. In model 1, the coefficient for ROA was negative and significant -0.0007 (z = -1.31). In model 2, the coefficient for ROA was negative and significant -0.000751 (z = -1.37).

Table 4.5

$$AEM = \alpha_0 + \alpha_1 PI_{j,t} + f(ControlVariables) + \varepsilon_{j,t} \quad \text{(Eq. 5)}$$

$$AEM = \alpha_0 + \alpha_1 PC_{j,t} + \alpha_2 GOVT_{j,t} + \alpha_3 BUR_{j,t} + f(ControlVariables) + \varepsilon_{j,t} \quad \text{(Eq. 6)}$$

	Regression 1 (Model 1)			Regression 2 (Model 2)		
AEM	**Coefficient**	**z**	**P>z**	**Coefficient**	**z**	**P>z**
PI	0.03196	3.99	0.000	....	....	....
PC	....	....	....	0.02312	3.11	0.001
GOVT	....	....	....	0.04654	2.28	0.0115
BUR	....	....	....	0.02111	1.8	0.036
ROA	-0.00070	-1.31	0.0955	-0.00075	-1.37	0.0855
LEV	-0.12523	-4.86	0.000	-0.12196	-4.64	0.000
SIZE	0.02855	1.32	0.0925	0.02356	1.01	0.1555
Growth	-0.04475	-2.38	0.0085	-0.04538	-2.43	0.0075
Loss	0.01984	1.1	0.135	0.02156	1.20	0.116
BIG4	-0.03146	-1.98	0.0235	-0.03086	-1.84	0.0325
_cons	-0.26625	-1.85	0.032	-0.24412	-1.61	0.054
Industry		Yes			Yes	
R-Squared		0.1577			0.1605	
Number		645			645	

Note: AEM is the residuals of accruals earnings management (accruals quality) model, which is calculated using Modified Dechow and Dichev (2002) Model, PI is the aggregate proxy of political influences, which includes all three characteristics of political influences in a single proxy; indicator value 1 for politically influenced firms and 0 otherwise, PC represents the presence of politicians or close relatives of politicians in board of directors; indicator value 1 for political connections and 0 otherwise, GOVT is the significant government ownership in a firm; indicator value 1 for government owned firms and 0 otherwise, BUR represents the presence of civil/military bureaucrat in board of directors; indicator value 1 for bureaucrats and 0 otherwise, ROA is the percentage of return on assets, LEV is ratio of debts on total assets, SIZE is the log of total assets, GROWTH is the percentage change in sales, Loss is the net loss of firms; indicator value 1 for firms producing losses and 0 otherwise, BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise; Number represents number of observations.

Moreover, leverage was significantly and negatively related to accruals earrings management in both models, because politically influenced firms are engaged in income-decreasing accruals earnings management activities. This view is also supported from a negative relationship between AEM and ROA, which implies that accruals earnings management is employed to report poor organizational performance in order to hide political gains and report less taxable income. Unlike prior studies which show that high leverage firms get involved in income-increasing earnings management activities in order to report better organizational performance, and thus continue debt covenant. In model 1, the coefficients for leverage (LEV) was negative and significant -0.1252 (z = -4.86). Whereas in model 2, the coefficients for leverage (LEV) was negative and significant -0.1219 (z = -4.64).

In addition, high growth firms were negatively and significantly related to accruals earnings management in both models, it means firms with high sales growth have better earnings quality (accruals quality) and less likely involved in accruals earnings management. The coefficient for growth in model 1 and 2 was negative and significant -0.0447 (z = -2.38) and -0.0453 (z = -2.43) respectively.

4.7.2 Relationship between Political Influences (combined proxy and multiple proxies) and Real Earnings Management

The R-Square for model 1 and 2 was 0.116 and 0.1167 respectively. The low R-Square is higher than the study of Braam, Nandy, Weitzel, and Lodh (2015), who reported 0.054. Model 1 in Table 4.6 shows the results of relationship between political influences (using combined aspects) and real earnings management. While model 2 of

Table 4.6, presents the results of relationship between political influences (using multiple aspects) and real earnings management.

Results of H2

The result shows that politically influenced firms are positively and significantly related to real earnings management, which implies that earnings quality is lower amongst politically influenced firms in terms of real earnings management. In model 1, the coefficient for the political influences (using combined aspect) was positive and significant 0.297753 (z = 4.22) using panel corrected standard error (PCSE) technique. This result is consistent with the findings of study by Braam, Nandy, Weitzel, and Lodh (2015), who stated that firms with political connections are more involved in real earnings management. Therefore, the results suggest that the presence of politically influenced people in board of directors (BOD) or management and significant government ownership increases real earnings management activities. Thus, this finding supports hypothesis 2.

Model 2 in Table 4.6, shows that political influences (through politically connected (PC) BOD) are significantly and positively related to real earnings management. The coefficient for the political connections was significant and positive 0.28304 (z = 3.17) using (PCSE) technique. This finding is in line with the results of study by Braam, Nandy, Weitzel, and Lodh (2015), who relates political connections with real earnings management. Hence, the results suggested that the presence of politician(s) in (BOD) or management increase real earnings management activities.

The positive and significant relationship between political influences (through significant government ownership) and real earnings management supports the view that firm with significant government ownership is related to real earnings management. The coefficient for the government ownership was significant and positive 0.212186 (z = 4.06) using (PCSE) technique. Thus, the findings suggest that firms with significant government ownership are more involved in real learnings management, implying lower earnings quality.

Moreover, the results show that firms are more involved in real earnings management when it has civil/military bureaucrat(s) in their board of directors (BOD) or management, which implies lower earnings quality in terms of real activities manipulation. The coefficient for the presence of bureaucrat in firms' BOD was significant and positive 0.155019 (z = 4.51). Zeng, Li, and Hong (2012) and Narayanaswamy (2013) also relate political influences (through civil/military bureaucracy) with poor earnings quality. Hence, the findings suggest that firms with the presence of civil/milatary bureaucrat(s) on the BOD are more involved in real earnings management and have lower earnings quality.

Results for Control Variables

Table 4.6, shows the relationship between control variables and real earnings management. There are seven control variables included in real earnings management model which represent the financial attributes of the firms, and industry being one of

these variables,. In model 1 and 2, the coefficient for firm size was significant and negative -0.25145 (z = -2.98) and -0.2568 (z = -3.03). Moreover, loss was not significantly related to real earnings management in both models. However, the coefficient for loss in model 1 was negative -0.0098 (z = -0.08) and positive in model 2 0.01040 (z = 0.08).

In addition, BIG4 auditors were positively and significantly related to real earnings management. In model 1 and 2, the coefficient for BIG4 was positive and significant 0.097485 (z = 1.34) and 0.096344 (z = 1.33) respectively. Furthermore, return on assets (ROA) was positively and significantly related to real earnings management in both models. This implies that firms audited by BIG4 auditors manipulate earnings through real earnings management in order to report better organizational performance, because real earnings management activities do not come under the jurisdictions of auditors. In model 1 and 2, the coefficient for ROA was positive and significant 0.0154 (z = 2.63) and 0.0157 (z = 2.55).

Moreover, the findings also reveal that high leverage firms are more involved in real earnings management and have lower earnings quality in terms of real activities manipulation. These findings are consistent with the view that high leverage firms get more involved in income-increasing earnings management activities in order to continue debt contracts. Leverage was positively and significantly related to real earrings management in both models. In model 1 and 2, the coefficients for leverage (LEV) was positive and significant 0.3658 (z = 2.63) and 0.3734 (z = 2.71) respectively.

Table 4.6

$$REM = \alpha_0 + \alpha_1 PI_{j,t} + f(ControlVariables) + \varepsilon_{j,t} \quad \text{(Eq. 7)}$$

$$REM = \alpha_0 + \alpha_1 PC_{j,t} + \alpha_2 GOVT_{j,t} + \alpha_3 BUR_{j,t} + f(ControlVariables) + \varepsilon_{j,t} \quad \text{(Eq. 8)}$$

	Regression 3 (Model 1)			Regression 4 (Model 2)		
REM	**Coefficient**	**z**	**P>z**	**Coefficient**	**z**	**P>z**
PI	0.29775	4.22	0.000	.....	.....	.....
PC	.....	.....	.....	0.28305	3.17	0.001
GOVT	.....	.....	.....	0.21219	4.06	0.000
BUR	.....	.....	.....	0.15502	4.51	0.000
ROA	0.0154	2.63	0.0045	0.0157	2.55	0.0055
LEV	0.36585	2.63	0.0045	0.37349	2.71	0.0035
SIZE	-0.2515	-2.98	0.0015	-0.2568	-3.03	0.001
GROWTH	0.08583	1.42	0.0785	0.08341	1.4	0.0805
LOSS	-0.0098	-0.08	0.468	0.0104	0.08	0.4665
BIG4	0.09748	1.34	0.09	0.09634	1.33	0.0925
_cons	1.30728	2.36	0.009	1.3171	2.36	0.009
Industry effect		Yes			Yes	
R-Squared		0.116			0.1167	
Number		645			645	

Note: REM is the aggregate residuals of real earnings management model, PI is the aggregate proxy of political influences, which includes all three characteristics of political influences in a single proxy; indicator value 1 for politically influenced firms and 0 otherwise, PC represents the presence of politicians or close relatives of politicians in board of directors; indicator value 1 for political connections and 0 otherwise, GOVT is the significant government ownership in a firm; indicator value 1 for government owned firms and 0 otherwise, BUR represents the presence of civil/military bureaucrat in board of directors; indicator value 1 for bureaucrats and 0 otherwise, ROA is the percentage of return on assets, LEV is ratio of debts on total assets, SIZE is the log of total assets, GROWTH is the percentage change in sales, Loss is the net loss of firms; indicator value 1 for firms producing losses and 0 otherwise, BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise, Number represents number of observations.

In addition, high growth firms are seen positively and significantly related to real earnings management in both models. This implies that firms with high sales growth are more involved in real earnings management. The coefficient for growth in model 1 and 2 was positive and significant 0.085827 (z = 1.42) and 0.083409 (z = 1.4) respectively.

4.7.3 Relationship between Political Influences (combined aspect and multiple aspects) and earnings opacity (earnings aggressiveness)

The R-Square for model 1 and 2 was 0.0723 and 0.0722 respectively. The low R-Square was consistent with previous studies. For example, Liu et al. (2016) reported 0.0786. Model 1 in Table 4.7 shows the results of relationship between political influences (using combined aspect) and earnings aggressiveness. While model 2 of Table 4.7, presents the results of relationship between political influences (using multiple aspects) and earnings aggressiveness.

Results of H3

The results show that politically influenced firms are positively and significantly related to earnings opacity (earnings aggressiveness), which implies that earnings lack transparency amongst politically influenced firms. In model 1, the coefficient for the political influences (using combined aspect) was positive and significant 0.027598 (z = 2.5) using panel corrected standard error (PCSE) technique. This result is consistent with the findings of study by Riahi-Belkaoui (2004), who stated that politically connected firms lack transparency and are related to earnings opacity. Therefore, the results show that the presence of politically influenced people in board of directors

(BOD) and significant government ownership increases earnings aggresivess, which results in reporting less transparent earnings numbers. Thus, this finding supported hypothesis 3.

Model 2 of Table 4.7, shows that political influences (through politically connected (PC) BOD) are significantly and positively related to earnings aggressiveness. The coefficient for the political connections was significant and positive 0.02641 (z = 2.25) using (PCSE) technique. This finding is in line with the findings of study by Riahi-Belkaoui (2004), who relates political connections with earnings aggressiveness (earnings opacity). Hence, the results suggest that the presence of politician(s) in (BOD) or management reduces transparency.

Further, the relationship between political influences (through significant government ownership) and earnings aggressiveness were positive, but not significant. It implies that significant government owned firms do not lack transparency. The coefficient for the government owned firms was positive and insignificant 0.01835 (z = 1.22) using (PCSE) technique.

The results show that a firm lacks transparency when it has civil/military bureaucrat(s) in their board of directors (BOD), which implies lower earnings quality in terms of transparency. The coefficient for the presence of bureaucrat in firms' BOD was significant and positive 0.01321 (z = 2.25). Narayanaswamy (2013); Zeng, Li, and Hong (2012) also relate political influences (through civil/military bureaucracy) with

poor earnings quality. Hence, the findings suggest that firms with the presence of civil/milatary bureaucrat(s) on the BOD are positively related to earnings aggressiveness.

Results for Control Variables

Table 4.7 shows the relationship between control variables and earnings aggressiveness including industry dummies, seven control variables were included in earnings aggressiveness attribute. In both models 1 and 2, return on assets (ROA), firms' debt to assets ratio (LEV) and sales growth (Growth) are negatively related to earnings aggressiveness. However, the LEV and Growth are significantly related to earnings aggressiveness, but ROA is not significant related to earnings aggressiveness. In model 1 and 2, the coefficient for firm's ROA is negative and insignificant -0.00044 (z = -0.8) and -0.00040 (z = -0.72).

In addition, the coefficient of LEV in both models is significant and negative -0.08169 (z = -3.12) and -0.08106 (z = -3.04). Moreover, the coefficient for Growth in model 1 and 2 is negative and significant -0.03677 (z = -2.03) and -0.03698 (z = -2.04) respectively.

Furthermore, BIG4 auditors, firm size and loss are positively, but not significantly related to earnings aggressiveness in both models. In model 1, the coefficient for BIG4, size and loss is positive and insignificant 0.00641 (z = 0.26), 0.019351 (z = 0.96) and 0.00772 (z = 0.57) respectively. Additionally, in model 2, the coefficient for BIG4, size

and loss is positive and insignificant 0.006268 (z = 0.25), 0.01922 (z = 0.96), and 0.009651 (z = 0.68) respectively.

Table 4.7

$$EA = \alpha_0 + \alpha_1 PI_{j,t} + f(ControlVariables) + \varepsilon_{j,t} \quad \text{(Eq. 9)}$$

$$EA = \alpha_0 + \alpha_1 PC_{j,t} + \alpha_2 GOVT_{j,t} + \alpha_3 BUR_{j,t} + f(ControlVariables) + \varepsilon_{j,t} \quad \text{(Eq. 10)}$$

	Regression 5 (Model 1)			Regression 6 (Model 2)		
EA	**Coefficient**	**z**	**P>z**	**Coefficient**	**z**	**P>z**
PI	0.0276	2.5	0.006	.....	.....	.....
PC	.....	.....	.....	0.02642	2.25	0.012
GOVT	.....	.....	.....	0.01836	1.22	0.1115
BUR	.....	.....	.....	0.01321	2.25	0.0125
ROA	-0.0004	-0.8	0.211	-0.0004	-0.72	0.237
LEV	-0.0817	-3.12	0.001	-0.0811	-3.04	0.001
SIZE	0.01935	0.96	0.169	0.01923	0.96	0.17
GROWTH	-0.0368	-2.03	0.021	-0.037	-2.04	0.021
LOSS	0.00773	0.57	0.2845	0.00965	0.68	0.2475
BIG4	0.00642	0.26	0.3955	0.00627	0.25	0.4
_cons	-0.2331	-1.87	0.0305	-0.234	-1.9	0.0285
R-Squared		0.0723			0.0722	
Industry effect		Yes			Yes	
Number		645			645	

Note: EA represents the earnings aggressiveness, calculated using Bhattacharya et al. (2003) model, , PI is the aggregate proxy of political influences, which includes all three characteristics of political influences in a single proxy; indicator value 1 for politically influenced firms and 0 otherwise, PC represents the presence of politicians or close relatives of politicians in board of directors; indicator value 1 for political connections and 0 otherwise, GOVT is the significant government ownership in a firm; indicator value 1 for government owned firms and 0 otherwise, BUR represents the presence of civil/military bureaucrat in board of directors; indicator value 1 for bureaucrats and 0 otherwise, ROA is the percentage of return on assets, LEV is ratio of debts on total assets, SIZE is the log of total assets, GROWTH is the percentage change in sales, Loss is the net loss of firms; indicator value 1 for firms producing losses and 0 otherwise, BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise.

4.7.4 Relationship between Political Connections (through ruling/opposition political party) and accruals earnings management

Table 4.8 shows the results of relationship between political connections (through ruling/opposition political party) and accruals earnings management (accruals quality).

Results of H4

The result shows that political connections through ruling political party are positively related to accruals earnings management, but not significant. It implies that the there is no difference in effect on accruals quality between political connections through ruling party or opposition party. The coefficient for the political connections is found positive and insignificant 0.009135 (z = 0.34) using panel corrected standard error (PCSE) technique. This result is also not consistent with the findings of study by Chaney, Faccio, and Parsley (2011), who state that political connections through ruling party are related to lower earnings quality (accruals quality). Therefore, the results suggest that compared to opposition party, the presence of political connections (through ruling party) in board of directors (BOD) does not make a significant impact on accruals earnings management (accruals quality). Thus, this finding does not support hypothesis 4.

Results for Control Variables

Return on assets (ROA) leverage (LEV), and loss are negatively related to accruals earnings management. However, ROA and LEV are also significantly related to accruals earnings management, but loss is not significantly related to accruals earnings

management. The coefficients for ROA, LEV, and Loss are -0.00281 (z = -2.13), -0.07644 (z = -3.21), and -0.01233 (z = -0.43) respectively.

Table 4.8

$$AEM = \alpha_0 + \alpha_1 PCR_{j,t} + f(ControlVariables) + \varepsilon_{j,t} \quad \text{(Eq. 11)}$$

	Regression 7		
AEM	**Coefficient**	**z**	**P>z**
PCR	0.0091346	0.34	0.367
ROA	-0.002808	-2.13	0.0165
LEV	-0.076439	-3.21	0.0005
SIZE	0.0137228	0.81	0.2075
GROWTH	0.0162687	0.58	0.28
LOSS	-0.012335	-0.43	0.3325
BIG4	0.0243855	1.05	0.146
_cons	-0.279559	-2.07	0.0195
R-Squared	0.1706		
Industry effect	Yes		
Number	185		

Note: AEM is the residuals of accruals earnings management (accruals quality) model, which is calculated using Modified Dechow and Dichev (2002) Model, PCR is the ruling party political connections; indicator value 1 for ruling party political connections and 0 opposition party political connections, ROA is the percentage of return on assets, LEV is ratio of debts on total assets, SIZE is the log of total assets, GROWTH is the percentage change in sales, Loss is the net loss of firms; indicator value 1 for firms producing losses and 0 otherwise, BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise.

In addition, natural log of total assets (Size), change in sales (growth), and BIG4 auditors are positively, but not significantly related to accruals earnings management

(accruals quality). The coefficients for size, growth, and BIG4 are 0.013723 (z = 0.81), 0.016269 (z = 0.58), 0.024386 (z = 1.05) respectively.

4.7.5 Relationship between Political Connections (through ruling/opposition political party) and real earnings management

Table 4.9 shows the relationship between political connection (through ruling/opposition political party) and real earnings management:

Results of H5

The result shows that political connections through ruling political party are negatively and significantly related to real earnings management. The coefficient for the political connections is negative and significant -0.599 (z = -2.46) using panel corrected standard error (PCSE) technique. This result is contrary to the findings of study by Chaney, Faccio, and Parsley (2011), who state that political connections through ruling party(s) are related to lower earnings quality. This is because; Chaney, Faccio, and Parsley (2011), does not employ real earnings management as a attribute of earnings quality. In addition to attribute, it is also argued that opposition party(s) politically connected firms are more engaged in real earnings management compared to ruling party(s) firms because regulators do not come under the direct influence of opposition party political connected people. Thus, they get more involved in less detectable real earnings management activities in comparison with ruling party(s) politically connected firms in order to avoid the detection by the regulators. Therefore, our results suggest that compared to ruling party(s) political connected firms, the presence of political

connections through opposition party(s) firms are more involved in real earnings management. Thus, our finding is contrary to our hypothesis 5 and does not support it.

Table 4.9

$$REM = \alpha_0 + \alpha_1 PCR_{j,t} + f(ControlVariables) + \varepsilon_{j,t} \quad \text{(Eq. 12)}$$

	Regression 8		
REM	**Coefficient**	**z**	**P>z**
PCR	-0.599004	-2.46	0.007
ROA	0.0227056	1.13	0.13
LEV	0.3977777	1.36	0.087
SIZE	-0.689826	-2.65	0.004
GROWTH	0.3988534	2.27	0.0115
LOSS	0.0762922	0.21	0.415
BIG4	-0.069338	-0.42	0.336
_cons	5.233054	2.51	0.006
R-Squared	0.3391		
Industry effect	Yes		
Number	185		

Note: REM is the aggregate residuals of real earnings management model, PCR is the ruling party political connections; indicator value 1 for ruling party political connections and 0 opposition party political connections, ROA is the percentage of return on assets, LEV is ratio of debts on total assets, SIZE is the log of total assets, GROWTH is the percentage change in sales, Loss is the net loss of firms; indicator value 1 for firms producing losses and 0 otherwise, BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise, Number represents number of observations.

Results for Control Variables

Table 4.9 shows the relationship between control variables and real earnings management. It is evident that Return on assets (ROA), firms' debt to assets ratio (LEV), sales growth (Growth) and loss are positively related to real earnings management. However, LEV and Growth are significantly related to real earnings management, but ROA and loss are significantly related to real earnings management. The coefficients for ROA and loss are positive and insignificant 0.022706 (z = 1.13) and 0.076292 (z = 0.21) respectively.

Similarly, the coefficients of LEV and Growth are positive and significant 0.397778 (z = 1.36) and 0.398853 (z = 2.27). Moreover, size and BIG4 are negatively related to real earnings management. However, size is significantly related, but BIG4 is not significantly related to real earnings management. The coefficients of size and BIG4 are -0.68983 (z = -2.65) and -0.06934 (z = -0.42).

4.7.6 Relationship between Political Connections (through ruling/opposition political party) and earnings aggressiveness

Table 4.10 shows the results of relationship between political connection (through ruling/opposition political party) and earnings aggressiveness.

Results of H6

The results show that political connections through ruling political party are positively related to earnings aggressiveness, but not significant. It implies that the there is no

difference in effect on transparency between political connections through ruling party and opposition party. The coefficient for the political connections was positive and insignificant 0.0133279 (z = 0.66) using panel corrected standard error (PCSE) technique. Contrary to the findings of study by Chaney, Faccio, and Parsley (2011), who stated that political connections through ruling party are related to lower earnings quality in terms of accruals. However, our findings show that compared to opposition party, the presence of political connections (through ruling party) in board of directors (BOD) does not make a significant impact on transparency (earnings aggressiveness). Thus, this finding does not support hypothesis 6.

Results for Control Variables

Return on assets (ROA), leverage (LEV), and loss are negatively related to earnings aggressiveness. However, ROA and LEV are significantly related to earnings aggressiveness, but loss is not significantly related to earnings aggressiveness. The coefficients for ROA, LEV, and Loss are -0.0019903 (z = -1.45), -0.0603083 (z = -2.56), and -0.0005534 (z = -0.02) respectively. In addition, natural log of total assets (SIZE), change in sales (GROWTH), and BIG4 auditors are positively, but not significantly related to earnings aggressiveness. The coefficients for SIZE, GROWTH, and BIG4 are 0.0127556 (z = 0.92), 0.0222957 (z = 1.27), and 0.0003342 (z = 0.02) respectively.

Table 4.10

$$EA = \alpha_0 + \alpha_1 PCR_{j,t} + f(ControlVariables) + \varepsilon_{j,t} \quad \text{(Eq. 13)}$$

	Regression 9		
EA	**Coefficient**	**z**	**P>z**
PCR	0.0133279	0.66	0.254
ROA	-0.00199	-1.45	0.073
LEV	-0.060308	-2.56	0.005
SIZE	0.0127556	0.92	0.18
GROWTH	0.0222957	1.27	0.1025
LOSS	-0.000553	-0.02	0.4915
BIG4	0.0003342	0.02	0.494
_cons	-0.139052	-1.31	0.0945
R-Squared	0.169		
Industry effect	Yes		
Number	185		

Note: EA represents the earnings aggressiveness, calculated using Bhattacharya et al. (2003) model, PCR is the ruling party political connections; indicator value 1 for ruling party political connections and 0 opposition party political connections, ROA is the percentage of return on assets, LEV is ratio of debts on total assets, SIZE is the log of total assets, GROWTH is the percentage change in sales, Loss is the net loss of firms; indicator value 1 for firms producing losses and 0 otherwise, BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise, Number represents number of observations.

4.7.7 Relationship between the interaction effect of political influences and accruals earnings management on real earnings management

Table 4.11 shows the results of the relationship between the interaction effects of political influences and accruals earnings management on real earnings management.

Results for H 7

Table 4.11 shows the results of the relationships between real earnings management and accruals earnings management, political influences and the interaction of accruals earnings management and political influences. The result shows the negative relationship between accrual earnings management and real earnings management, but not significant. The coefficient of accruals earnings management is negative and insignificant -0.14217 (z = -0.7). The result also shows the positive and significant relationship between political influences and real earnings management, which implies that politically influenced firms are more involved in real earnings management. However, the interaction of accruals earnings management with political influences is negatively and significantly related to real earnings management. It implies that politically influenced firms substitute accruals earnings management for real earnings management. This result is congruent with previous studies (Braam, Nandy, Weitzel, and Lodh, 2015; Zang, 2011; Cohen and Zarowin, 2010; Cohen, Dey, and Lys, 2008), that state that firms substitute real earnings management for accrual-based earnings management.

The coefficient for political influences is positive and significant 0.144277 (z = 1.88). While, the coefficient for the interaction of accruals earnings management and political

influences is negative and significant -1.14588 (z = -2.3). Therefore, these findings suggest that politically influenced firms are likely to substitute accrual earnings management strategy for real earnings management strategy compared to non-politically influenced firms. Thus, our findings support Hypothesis 7.

Table 4.11

$$REM = \alpha_0 + \alpha_1 AEM_{j,t} + \alpha_2 PI_{j,t} + \alpha_3 PIAEM_{j,t} + f(ControlVariables) + \varepsilon_{j,t} \quad \text{(Eq. 14)}$$

	Regression 10		
REM	**Coefficient**	**z**	**P>z**
AEM	-0.1422	-0.7	0.2425
PI	0.14428	1.88	0.0295
PIAEM	-1.1459	-2.3	0.011
ROA	0.01346	2.52	0.006
LEV	0.26967	1.9	0.029
SIZE	-0.2350	-2.78	0.0025
GROWTH	0.0808	1.43	0.076
LOSS	-0.0167	-0.14	0.4425
BIG4	0.08926	1.26	0.1035
_cons	1.26459	2.18	0.0145
R-Squared		0.1372	
Industry effect		Yes	
Number		645	

Note: REM is the aggregate residuals of real earnings management model, AEM is the residuals of accruals earnings management (accruals quality) model, which is calculated using Modified Dechow and Dichev (2002) Model, PI is the aggregate proxy of political influences, which includes all three characteristics of political influences in a single proxy; indicator value 1 for politically influenced firms and 0 otherwise, PIAEM represents the interaction effect of PI and AEM, PC represents the presence of politicians or close relatives of politicians in board of directors; indicator value 1 for political connections

and 0 otherwise, GOVT is the significant government ownership in a firm; indicator value 1 for government owned firms and 0 otherwise, BUR represents the presence of civil/military bureaucrat in board of directors; indicator value 1 for bureaucrats and 0 otherwise, PCAEM represents the interaction effect of PC and AEM, BURAEM represents the interaction effect of BUR and AEM, GOVAEM represents the interaction effect of GOVT and AEM, ROA is the percentage of return on assets, LEV is ratio of debts on total assets, SIZE is the log of total assets, GROWTH is the percentage change in sales, Loss is the net loss of firms; indicator value 1 for firms producing losses and 0 otherwise, BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise.

Result for Control Variable

Table 4.11 shows the relationship between control variables and real earnings management. Return on assets (ROA), firms' debt to assets ratio (LEV), sales growth (Growth) and BIG4 auditors are positively related to real earnings management. However, ROA, LEV, and Growth are significantly related to real earnings management, but BIG4 is not significantly related to real earnings management. The coefficients for ROA, LEV, Growth, and BIG4 are 0.013463 (z = 2.52), 0.269674 (z = 1.9), 0.080001 (z = 1.43), and 0.089255 (z = 1.26) respectively.

Moreover, SIZE and LOSS are negatively related to real earnings management. However, SIZE is significantly related, but LOSS is not significantly related to real earnings management. The coefficient of SIZE is negative and significant -0.23502 (z = -2.78). The coefficient of LOSS is negative and insignificant -0.01671 (z = -0.14).

4.8 Alternative measures of Earnings Quality Attributes

We performed a number of sensitivity analyses to examine the robustness of our findings. As a robustness test, three measures of accruals earnings management were tested, and two measures of real earnings management were tested. In addition, to check the robustness of regression ten, we employed multiple proxies of political influences.

4.8.1 Sensitivity Analysis for Accruals Earnings Management Model (Accruals Quality) and Political Influences (using single aspect)

In addition to the residuals obtained through the modified Dechow and Dichev (2002) model, we performed additional three measures of accruals earnings management. The first additional measure of accruals earnings management uses the signed abnormal residuals from the regression of the modified Dechow and Dichev (2002) model. The second alternative measure is the residuals from the unmodified (original) Dechow and Dichev (2002) model. The third alternative measure of accruals earnings management uses the absolute value residuals from the regression of the modified Jones model (1995). Table 4.12 compares the results of regression 1 using the absolute reriduals measure (main results) and the results of three alternative measures. As shown in Table 4.12, the findings of all three alternative measures are consistent with the main results, which shows the positive and significant relationship between political influences (using single aspect) and accruals earniings management. However, the coefficients are higher and p-values are more significant for modified Dechow and Dichev (2002) model i.e. the main model. This signifies that the main model employed for accruals earnings management can be considered more robust against three alternative measures of accruals earnings management.

Table 4.12

Alternative measures of accruals earnings management with single proxy of political influences

	Signed AEM			**(Unmodified DD)**			**Modified Jones Model**		
	Coefficient	**z**	**P>z**	**Coefficient**	**z**	**P>z**	**Coefficient**	**z**	**P>z**
PI	0.0168	1.46	0.0725	0.02399	2.04	0.0205	0.02971	2.32	0.01
ROA	-0.0009	-0.66	0.255	-0.0006	-0.94	0.174	-0.0008	-0.53	0.299
LEV	0.05404	1.3	0.0975	-0.0771	-2.83	0.0025	-0.1768	-2.8	0.0025
SIZE	0.03368	5.61	0.000	0.04195	1.94	0.0265	0.11945	3.02	0.0015
Growth	0.06128	2.95	0.0015	-0.0362	-1.92	0.0275	0.00281	0.07	0.4705
LOSS	-0.0198	-0.66	0.255	0.01446	0.79	0.2155	0.05735	1.36	0.087
BIG4	0.01789	0.62	0.268	-0.0188	-1.11	0.134	-0.0693	-1.69	0.0455
_cons	-0.2994	-5.96	0	-0.4159	-2.95	0.0015	-0.9115	-3.23	0.0005
R-Squared		0.0261			0.1055			0.0646	
Industry effect		Yes			Yes			Yes	
Number		645			645			645	

Note: Signed AEM is the signed residuals of accruals earnings management (accruals quality) model, which is calculated using Modified Dechow and Dichev (2002) Model; Unmodified DD is the absolute residuals of accruals earnings management (accruals quality) model, which is calculated using unmodified Dechow and Dichev (2002) Model; Modified Jones Models is the absolute residuals of accruals earnings management (accruals quality) model, which is calculated using Dechow (1995) Model; PI is the aggregate proxy of political influences, which includes all three characteristics of political influences in a single proxy; indicator value 1 for politically influenced firms and 0 otherwise; ROA is the percentage of return on assets, LEV is ratio of debts on total assets, SIZE is the log of total assets, GROWTH is the percentage change in sales, LOSS is the net loss of firms; indicator value 1 for firms producing losses and 0 otherwise, BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise; Number represents number of observations.

4.8.2 Sensitivity Analysis for Accruals Earnings Management Model (Accruals Quality) and Political Influences (using multiple proxies)

As a robustness test for regression 2, three different measures of accruals earnings management were tested, in addition to the residuals obtained from the modified Dechow and Dichev (2002) model. The first additional measure of accruals earnings management uses the signed abnormal residuals from the regression of the modified Dechow and Dichev (2002) model. The second alternative measure is the residuals from the unmodified (original) Dechow and Dichev (2002) model. The third alternative measure of accruals earnings management uses the absolute value residuals from the regression of the modified Jones model (1995).

Table 4.13 compares the results of regression 2 using the absolute residuals measure (main results) and the results of three alternative measures. As shown in Table 4.13, the findings of all three alternative measures are consistent with the main results for the PC, which shows the positive and significant relationship between PC and accruals earnings management. However, GOVT remain significant with the same sign using original (unmodified) Dechow and Dichev model. While the results are not consistent when using the signed measure of Dechow and Dichev (2002) and modified Jones model (1995). Moreover, as shown in the Table 4.13, the results for BUR are similar for modified Dechow and Dichev (2002) and modified Jones model (1995). However, the BUR becomes insignificant when original (unmodified) Dechow and Dichev model and signed residuals from the modified Dechow and Dichev model is used. This suggests that the results of PC, GOVT, and BUR in BOD can be considered more robust when

using the modified Dechow and Dichev (2002) model compared to alternative measures of AEM.

Table 4.13
Alternative measures of accruals earnings management with multiple aspects of political influences

	Signed AEM			(Unmodified DD)			Modified Jones Model (1995)		
AEM	**Coefficient**	**Z**	**P>z**	**Coefficient**	**z**	**P>z**	**Coefficient**	**z**	**P>z**
PC	0.01643	1.28	0.1	0.0205	1.33	0.091	0.02627	2.14	0.016
GOVT	0.03101	1.09	0.137	0.025	2.08	0.019	-0.01132	-0.62	0.268
BUR	-0.01815	-1.08	0.140	0.0102	0.94	0.174	0.03719	1.92	0.027
ROA	-0.00078	-0.58	0.282	-0.0006	-0.84	0.200	-0.00079	-0.57	0.284
LEV	0.05453	1.28	0.099	-0.0758	-2.63	0.004	-0.17578	-2.74	0.003
SIZE	0.03362	5.94	0.000	0.0406	1.93	0.027	0.12175	3.13	0.001
Growth	0.06067	2.91	0.002	-0.0365	-1.94	0.026	0.00317	0.08	0.467
LOSS	-0.01858	-0.62	0.267	0.016	0.84	0.201	0.05982	1.4	0.080
BIG4	0.01958	0.65	0.256	-0.0186	-1.06	0.145	-0.07203	-1.74	0.041
_cons	-0.29263	-6.89	0	-0.4104	-2.96	0.001	-0.92622	-3.36	0.0005
R-Squared		0.027			0.105			0.064	
Industry effect		Yes			Yes			Yes	
Number		645			645			645	

Note: Signed AEM is the signed residuals of accruals earnings management (accruals quality) model, which is calculated using Modified Dechow and Dichev (2002) Model; Unmodified DD is the absolute residuals of accruals earnings management (accruals quality) model, which is calculated using unmodified Dechow and Dichev (2002) Model; Modified Jones Models is the absolute residuals of accruals earnings management (accruals quality) model, which is calculated using Dechow (1995) Model; PC represents the presence of politicians or close relatives of politicians in board of directors; indicator

value 1 for political connections and 0 otherwise, GOVT is the significant government ownership in a firm; indicator value 1 for government owned firms and 0 otherwise, BUR represents the presence of civil/military bureaucrat in board of directors; indicator value 1 for bureaucrats and 0 otherwise; ROA is the percentage of return on assets, LEV is ratio of debts on total assets, SIZE is the log of total assets, GROWTH is the percentage change in sales, LOSS is the net loss of firms; indicator value 1 for firms producing losses and 0 otherwise, BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise; Number represents number of observations.

4.8.3 Sensitivity Analysis for Real Earnings Management Model (using individual measure) and Political Influences (using single aspect)

To test whether our results are sensitive to alternative measures of real earnings management, we considered individual measures (i.e. over-productions of goods to reduce cost, and reducing discretionary expenditures) as alternative measures of real earnings management.

For this reason, we repeated our analysis for regression 3 by using the individual measures of real earnings management as dependent variables. These alternative measures have also been adopted by Braam, Nandy, Weitzel, and Lodh (2015). Our results for alternative measures are consistent with the main results, which means that political influences (using single aspect) are positive and significant related to real earnings management (using individual measures). Therefore, this could be suggested from the results that politically influenced firms are involved in both individual measures of real earnings management (i.e. over-production, and reducing discretionary expense). However, the coefficients of real earnings management (through discretionary expenditure) is higher compared to managing earnings through over-production, implies that political influences firms are comparatively engaged more in managing earnings through discretionary expenditures.

Table 4.14
Alternative measures of real earnings management with single proxy of political influences

	REM_PROD			REM_DISX		
	Coefficient	**z**	**P>z**	**Coefficient**	**z**	**P>z**
PI	0.0989116	3.15	0.001	0.19884	3.62	0.000
ROA	0.0049625	3.06	0.001	0.010441	1.73	0.042
LEV	0.0453165	0.62	0.2675	0.32053	2.61	0.0045
SIZE	-0.021361	-0.63	0.265	-0.23009	-3.63	0.000
Growth	0.0256497	0.6	0.275	0.060178	1.01	0.1575
Loss	-0.035465	-0.94	0.1745	0.025651	0.23	0.4075
BIG4	0.1420263	4.71	0.000	-0.04454	-0.54	0.295
_cons	-0.032762	-0.13	0.448	1.340037	3.45	0.0005
R-Squared		0.076			0.086	
Industry effect		Yes			Yes	
Number		645			645	

Note: REM_PROD is the residuals of real earnings management activities through over-production of goods; REM_DISX is the residuals of real earnings management activities through reducing discretionary expenditures; PI is the aggregate proxy of political influences, which includes all three characteristics of political influences in a single proxy; indicator value 1 for politically influenced firms and 0 otherwise; ROA is the percentage of return on assets; LEV is ratio of debts on total assets; SIZE is the log of total assets; GROWTH is the percentage change in sales; LOSS is the net loss of firms; indicator value 1 for firms producing losses and 0 otherwise; BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise; Number represents number of observations.

4.8.4 Sensitivity Analysis for Real Earnings Management Model (using individual measures) and Political Influences (using multiple aspects)

To test the robustness of regression 4, following Braam, Nandy, Weitzel, and Lodh (2015), we repeated our analysis by using the individual measures of real earnings management as dependent variables and multiple proxies of political influences as explanotry variables. As shown in Table 4.15, the results of individual measures are not consistent with the main results (i.e. aggregate measure of real earnings management). Political influences (through government ownership (GOVT) and bureaucrats (BUR) in BOD) are positively and significantly related to real earnings management (through over-productions). However, political influences (through politicians in BOD) are positive, but not significant. It shows that GOVT and BUR are more involved in manipulating earnings through over-production compared to non-politically influenced firms. However, PC firms are not significantly involved in earnings management through over-productions of goods.

In addition, as shown in the Table 4.15, PC firms are positively and significantly related to real earnings management (through reducing discretionary expenditures). However, political influences (through GOVT and BUR) are not significantly related to real earnings management (through discretionary expenditures). It shows that GOVT and BUR are not involved in manipulating earnings through reducing discretionary expenses. However, PC firms are significantly involved in manipulating real activities through reducing discretionary expenditures.

Table 4.15

Alternative measures of real earnings management with multiple proxies of political influences

	REM_PROD			REM_DISX		
	Coefficient	**z**	**P>z**	**Coefficient**	**z**	**P>z**
PC	0.0362919	1.13	0.129	0.246755	3.52	0.000
GOVT	0.2390403	7.6	0.000	-0.02685	-0.63	0.2635
BUR	0.1102556	3.59	0.000	0.044764	1.27	0.1025
ROA	0.0043268	2.51	0.006	0.011374	1.8	0.0355
LEV	0.0671887	0.96	0.168	0.3063	2.5	0.006
SIZE	-0.057766	-1.86	0.0315	-0.19903	-3.03	0.001
GROWTH	0.0223922	0.58	0.28	0.061017	1.03	0.1515
LOSS	-0.032344	-0.88	0.1905	0.042748	0.38	0.3505
BIG4	0.1457664	4.86	0.000	-0.04942	-0.6	0.2755
_cons	0.1344311	0.56	0.2885	1.182671	2.96	0.0015
R-Squared		0.105			0.089	
Industry effect		Yes			Yes	
Number		645			645	

Note: REM_PROD is the residuals of real earnings management activities through over-production of goods; REM_DISX is the residuals of real earnings management activities through reducing discretionary expenditures; PC represents the presence of politicians or close relatives of politicians in board of directors; indicator value 1 for political connections and 0 otherwise; GOVT is the significant government ownership in a firm; indicator value 1 for government owned firms and 0 otherwise; BUR represents the presence of civil/military bureaucrat in board of directors; indicator value 1 for bureaucrats and 0 otherwise; ROA is the percentage of return on assets; LEV is ratio of debts on total assets; SIZE is the log of total assets; GROWTH is the percentage change in sales; LOSS is the net loss of firms; indicator value

1 for firms producing losses and 0 otherwise; BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise; Number represents number of observations.

4.8.5 Sensitivity Analysis for the interaction of political influences and accruals earnings management on real earnings management

To check the sensitivity of our results for regression 10, we repeated our analysis by using the interaction effects of political influences (using multiple aspects) and accruals earnings management on aggregate measure of real earnings management. In order to see the interaction effects of political influences and accruals earnings management on real earnings management, we introduced the interaction term (i.e. PC*AEM, GOVT*AEM, and BUR*AEM). As shown in the Table 4.16, the relationship between accrual earnings management (AEM) and real earnings management (REM) is consistent with the main results, which shows negative but not significant relationship between REM and AEM. Consistent with the main results, the interaction of accruals earnings management with political influences (PC firms) is negatively and significantly related to real earnings management; it implies that PC firms substitute accruals earnings management for real earnings management.

However, the interaction of accruals earnings management with political influences (through GOVT and BUR) are not significantly related to real earnings management, which means that GOVT and BUR firms do not substitute accruals earnings management for real earnings management. These findings suggested that the types of political influences need to be clearly specified.

Table 4.16

Alternative results for the interaction effect of political influences and accruals earnings management on real earnings management

REM	Coefficient	z	P>z
AEM	-0.179495	-0.86	0.392
PC	0.0668649	0.67	0.503
GOVT	0.1886892	3.8	0.000
BUR	0.1624756	4.05	0.000
PCAEM	-1.586512	-2.17	0.03
GOVAEM	-0.321939	-0.76	0.445
BURAEM	0.0709585	0.28	0.782
ROA	0.0135785	2.45	0.014
LEV	0.2604188	1.84	0.066
SIZE	-0.234749	-2.77	0.006
Growth	0.0798444	1.39	0.165
Loss	-0.000103	0	0.999
BIG4	0.0978313	1.58	0.115
_cons	1.222169	2.14	0.032
R-Squared		0.143	
Industry effect		Yes	
Number		645	

Note: REM is the aggregate residuals of real earnings management model which is calculated using Roychowdhury (2006) model; AEM is the residuals of accruals earnings management (accruals quality) model, which is calculated using Modified Dechow and Dichev (2002) Model; PC represents the presence of politicians or close relatives of politicians in board of directors; indicator value 1 for political connections and 0 otherwise; GOVT is the significant government ownership in a firm; indicator value 1 for government owned firms and 0 otherwise; BUR represents the presence of civil/military bureaucrat in

board of directors; indicator value 1 for bureaucrats and 0 otherwise; PCAEM is the interaction effect of PC and AEM; GOVAEM represents the interaction effect of GOVT and AEM; BURAEM is the interaction effect of BUR and AEM; ROA is the percentage of return on assets, LEV is ratio of debts on total assets, SIZE is the log of total assets, GROWTH is the percentage change in sales, LOSS is the net loss of firms; indicator value 1 for firms producing losses and 0 otherwise, BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise; Number is the number of observations.

4.8.6 Sensitivity Analysis using different aspects of political influences individually

We employed and included multiple aspects of political influences (i.e. political connections (PC), government ownership (GOVT), and Bureaucracy (BUR)) in regression, 2, 4, and 6. It is possible that including all aspects of political influences as explanatory variables in a single regression may weaken the significance of each individual coefficient to the extent that significance disappears. Although this could be identified using correlation coefficients matrix and Variance inflation factor; however, as an additional test, each political influences aspects was used individually as a proxy of political influences.

Table 4.17 shows that the individual use of the political influences aspects do not significantly change the results from main results. However, as shown in Table 4.17 and 4.21, using multiple aspects of political influences individually in regression 2 and 4 changed the significant level of all three aspects of political influences to 1%. In addition, the insignificant relationship (in regression 6) between earnings aggressiveness with government owned (GOVT) firms changed to significant relationship at 5% significant level.

Table 4.17

Regression results of multiple aspects of political influences (using individually) and accruals earnings management

AEM	Coef.	z	P>z	Coef.	z	P>z	Coef.	z	P>z
PC	0.01991	2.8	0.0025	....	.....	.....	....	.....	.....
GOVT	....	.....	.....	0.05360	3.09	0.001	....	.....	.....
BUR	....	.....	.....	.....	.....	....	0.02993	3.3	0.0005
ROA	-0.00055	-1.03	0.152	-0.00069	-1.33	0.091	-0.0007	-1.34	0.0895
LEV	-0.12162	-4.61	0	-0.11506	-4.58	0	-0.1157	-4.61	0
SIZE	0.03459	1.62	0.053	0.02613	1.11	0.133	0.03146	1.52	0.0645
GROWTH	-0.04491	-2.37	0.009	-0.04585	-2.45	0.007	-0.0449	-2.39	0.0085
LOSS	0.02336	1.25	0.106	0.02268	1.23	0.1095	0.02344	1.27	0.103
BIG4	-0.03365	-2.13	0.0165	-0.03213	-1.96	0.0245	-0.036	-2.27	0.0115
_cons	-0.29826	-2.07	0.019	-0.2579	-1.69	0.0455	-0.2864	-2.02	0.0215
R-Squared		0.153			0.157			0.154	
Industry effect		Yes			Yes			Yes	

Note: AEM is the residuals of accruals earnings management (accruals quality) model, which is calculated using Modified Dechow and Dichev (2002) Model; PC represents the presence of politicians or close relatives of politicians in board of directors; indicator value 1 for political connections and 0 otherwise, GOVT is the significant government ownership in a firm; indicator value 1 for government owned firms and 0 otherwise, BUR represents the presence of civil/military bureaucrat in board of directors; indicator value 1 for bureaucrats and 0 otherwise; ROA is the percentage of return on assets, LEV is ratio of debts on total assets, SIZE is the log of total assets, GROWTH is the percentage change in sales, LOSS is the net loss of firms; indicator value 1 for firms producing losses and 0 otherwise, BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise.

Table 4.18

Regression results of multiple aspects of political influences (using individually) and real earnings management

REM	Coef.	z	P>z	Coef.	z	P>z	Coef.	z	P>z
PC	0.26307	2.94	0.001	....	.....	.....	....	.....	.....
GOVT	....	.....	.....	0.25666	4.98	0.000	....	.....	.....
BUR	....	.....	.....	....	.....	.....	0.17145	4.6	0.000
ROA	0.01690	2.75	0.003	0.01596	2.65	0.004	0.01555	2.51	0.006
LEV	0.37645	2.7	0.003	0.45764	3.21	0.0005	0.4548	3.15	0.001
SIZE	-0.1984	-2.58	0.005	-0.23184	-2.85	0.002	-0.2101	-2.76	0.003
Growth	0.08505	1.39	0.082	0.07908	1.36	0.0875	0.08401	1.42	0.078
LOSS	0.02008	0.16	0.435	0.02297	0.19	0.4265	0.02602	0.2	0.42
BIG4	0.08421	1.15	0.125	0.07614	0.97	0.166	0.05691	0.74	0.2295
_cons	1.03312	1.99	0.023	1.17452	2.21	0.0135	1.05526	2.06	0.02
Industry effect		Yes			Yes			Yes	
R-Squared		0.105			0.095			0.093	

Note: REM is the aggregate residuals of real earnings management model, PC represents the presence of politicians or close relatives of politicians in board of directors; indicator value 1 for political connections and 0 otherwise, GOVT is the significant government ownership in a firm; indicator value 1 for government owned firms and 0 otherwise, BUR represents the presence of civil/military bureaucrat in board of directors; indicator value 1 for bureaucrats and 0 otherwise, ROA is the percentage of return on assets, LEV is ratio of debts on total assets, SIZE is the log of total assets, GROWTH is the percentage change in sales, LOSS is the net loss of firms; indicator value 1 for firms producing losses and 0 otherwise, BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise.

Table 4.19

Regression results of multiple aspects of political influences (using individually) and earnings aggressiveness

EA	Coef.	z	P>z	Coef.	z	P>z	Coef.	z	P>z
PC	0.02471	2.13	0.0165	....	.....	.....	....	.....	.....
GOVT	....	.....	.....	0.022	1.66	0.0485	....	.....	.....
BUR	....	.....	.....	....	.....	....	0.01437	3.16	0.001
ROA	-0.0003	-0.53	0.2995	-0.0004	-0.7	0.242	-0.0004	-0.75	0.225
LEV	-0.0808	-3.03	0.001	-0.0732	-2.98	0.0015	-0.0735	-3.00	0.0015
SIZE	0.02425	1.3	0.0965	0.02148	1.11	0.134	0.02339	1.27	0.1015
GROWTH	-0.0368	-2.02	0.0215	-0.0374	-2.05	0.0205	-0.0369	-2.03	0.0215
LOSS	0.01048	0.72	0.235	0.01081	0.74	0.2305	0.01108	0.75	0.226
BIG4	0.00522	0.22	0.4135	0.00433	0.18	0.4275	0.00268	0.12	0.4535
_cons	-0.2585	-2.2	0.014	-0.247	-2.08	0.0185	-0.2574	-2.22	0.013
Industry effect		Yes			Yes			Yes	
R-Squared		0.070			0.068			0.067	

Note: EA represents the earnings aggressiveness, calculated using Bhattacharya et al. (2003) model, PC represents the presence of politicians or close relatives of politicians in board of directors; indicator value 1 for political connections and 0 otherwise, GOVT is the significant government ownership in a firm; indicator value 1 for government owned firms and 0 otherwise, BUR represents the presence of civil/military bureaucrat in board of directors; indicator value 1 for bureaucrats and 0 otherwise, ROA is the percentage of return on assets, LEV is ratio of debts on total assets, SIZE is the log of total assets, GROWTH is the percentage change in sales, LOSS is the net loss of firms; indicator value 1 for firms producing losses and 0 otherwise, BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise.

4.8.7 Sensitivity analysis for the relationship between direct and indirect political connections and earnings quality attributes

The result shows that direct political connected (DPC) firms (presence of politicians in a firm) are positively and significantly related to accruals earnings management compared to indirect political connected (IDPC) firms (presence of close relatives of politicians in a firm). However, our results suggest that compared to DPC, indirect politically connected (IDPC) firms are more engaged in real earnings management. Moreover, DPC firms are significantly and positively related to earnings aggressiveness. It implies that DPC firms lack transparency compared to IDPC firms.

Therefore, it is argued that DPC firms are reporting poor earnings quality compared to IDPC firms when earnings quality is measured through accruals attributes. In addition, IDPC firms are reporting poor earnings quality compared to DPC firms when earnings quality is measured through real earnings management attribute.

Table 4.20

Regression results of direct/indirect political connections, and real and accruals earnings management

	AEM			REM		
	Coefficient	**z**	**P>z**	**Coefficient**	**z**	**P>z**
DPC	0.0712331	2.77	0.006	-0.4245	-2.71	0.007
ROA	-0.002657	-2.07	0.038	0.022484	1.05	0.292
LEV	-0.076341	-3.18	0.001	0.34065	1.1	0.271
SIZE	0.026408	1.57	0.116	-0.72971	-2.65	0.008
GROWTH	0.0203668	0.76	0.448	0.417133	2.13	0.033
LOSS	-0.01533	-0.57	0.569	0.17578	0.45	0.655
BIG4	0.027845	1.23	0.217	-0.14156	-0.81	0.419
_cons	-0.383404	-2.87	0.004	5.069001	2.47	0.013
Industry effect		Yes			Yes	
R-Squared		0.1996			0.3155	
Number		185			185	

Note: AEM is the residuals of accruals earnings management (accruals quality) model, which is calculated using Modified Dechow and Dichev (2002) Model, REM is the aggregate residuals of real earnings management model, which is calculated using Roychowdhury (2006) model, DPC represents direct political connections; indicator value 1 in presence of politician(s) in board of directors or senior management i.e. direct political connections and 0 in presence of close relative(s) of politician(s) in board of directors or senior management i.e. indirect political connections, ROA is the percentage of return on assets, LEV is ratio of debts on total assets, SIZE is the log of total assets, GROWTH is the percentage change in sales, LOSS is the net loss of firms; indicator value 1 for firms producing losses and 0 otherwise, BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise, Number represents number of observations.

Table 4.21

Regression results of direct/indirect political connections ands earnings aggressiveness

EA	Coefficient	z	P>z
DPC	0.0268498	3.79	0.000
ROA	-0.001945	-1.41	0.16
LEV	-0.059245	-2.48	0.013
SIZE	0.0168887	1.18	0.237
Growth	0.0230653	1.35	0.178
Loss	-0.003164	-0.13	0.901
BIG4	0.0025748	0.12	0.905
_cons	-0.163984	-1.61	0.107
Industry effect		Yes	
R-Squared		0.1737	
Number		185	

Note: EA represents the earnings aggressiveness, calculated using Bhattacharya et al. (2003) model, DPC represents direct political connections; indicator value 1 in presence of politician(s) in board of directors or senior management i.e. direct political connections and 0 in presence of close relative(s) of politician(s) in board of directors or senior management i.e. indirect political connections, ROA is the percentage of return on assets, LEV is ratio of debts on total assets, SIZE is the log of total assets, GROWTH is the percentage change in sales, Loss is the net loss of firms; indicator value 1 for firms producing losses and 0 otherwise, BIG4 is the top four audit firms in the world; indicator value 1 for BIG4 auditors and 0 otherwise.

CHAPTER FIVE

FINDINGS AND DISCUSSION

5.0 Introduction

This chapter provides an overview of the findings and a detailed discussion of the results, contributions of the present study, and its limitations. The chapter also gives suggestions for future research that would extend the body of knowledge in financial reporting quality and audit pricing literature. The last sections highlight the limitations and conclusion of the study.

5.1 Overview of the Study

This study was motivated to empirically achieve three main objectives mentioned in chapter one: 1) to examine the relationship between political influences and earnings quality; 2) To examine whether ruling party politically connected firms are reporting poor earnings quality compared to opposition party politically connected firms; 3) to investigate whether politically influenced firms substitute real earnings management strategy for accruals earnings management.

Previous studies have documented that politically influenced firms are related to lower earnings quality. For example, some studies have documented that politically connected firms are significantly associated with earnings management (for e.g., Harymawan and Nowland, 2016; Liu, Li, Zeng, and An, 2016; Al-dhamari and Ismail, 2015, Chaney, Faccio, and Parsley, 2011). Other studies provide evidence that the reported earnings

lack transparency in politically connected firms (e.g., Riahi-Belkaoui, 2004). Congruent to these studies, the findings of (hypotheses 1 to 3) show the negative relationship between political influences and earnings quality.

In addition, Chaney, Faccio, and Parsley (2011) opine that politically connected firms through ruling political party have poorer earnings quality compared to opposition party politically connected firms. Contrary to this study, the findings of (Hypothesis 5) shows that opposition party politically connected firms are more involved in real earnings management and reporting poor earnings quality compared to ruling party politically connected firms. Further, the findings of Hypotheses 4 and 6 shows that there is no difference in effect of ruling and opposition party political connections on earnings quality when earnings quality is measured by accruals attributes of earnings quality.

Recently, Braam, Nandy, Weitzel, and Lodh (2015) show that politically influenced firms substitute real earnings management for accruals earnings management. However, this study enriched existing literature by using three aspects of politically influenced firms. Congruent with previous studies, it is also found (Hypothesis 7) that politically influenced firms' substitute real earnings management strategy for accruals earnings management.

The independent variables (i.e. three aspects of political influences) were selected based on prior literature. Three attributes of earnings quality were employed and modified. These attributes were the accruals quality (accruals earnings management) model of

Dechow and Dichev (2002) as modified by McNichols (2002), the real earnings management model of Roychowdhury (2006), the earnings aggressiveness model of Bhattacharya, Daouk, and Welker (2003). Seven control variables were used for all three earnings quality attributes. Data (i.e. Financial Position, Income Statement, Cash Flow, and Financial Ratios) of non-financial listed firms in Pakistan Stock Exchange (PSE) were collected from State Bank of Pakistan (SBP) and PSE websites. The sample comprised 645 observations for the five-year (panel data) period from 2009 to 2013. Stata statistical software was used to analyze the panel data. Panel Corrected Standard Error (PCSE) technique was employed to analyze the data. In presence of Heteroskedasticity, and when panel includes large number of observations, then PCSE technique is more appropriate compared to generalized least square (GLS) (Gujarati, 2009). Therefore, PCSE technique was used for our analysis; seven hypotheses from all three attributes of earnings quality were tested and analyzed.

5.2 Overview of Results

Table 5.1 to 5.5 below presents and summarizes the results of this study. As shown in the tables, four hypotheses are supported, two are not supported and one is contradicted and not supported.

Table 5.1
Summary of Hypotheses Testing for Political Influences and Accruals Earnings Management

	Hypothesis	Results
H1:	Politically influenced firms have lower accruals quality compared to non-politically influenced firm.	Supported
H1a:	Political influences (in presence of politician(s) in BOD) have lower accruals quality compared to non-politically influenced firms.	Supported
H1b:	Political influences (through significant government ownership) have lower accruals quality compared to non-politically influenced firms.	Supported
H1c:	Political influences (in presence of civil/military bureaucrat(s) on BOD) have lower accruals quality compared to non-politically influenced firms.	Supported

Table 5.2
Summary of Hypotheses Testing for Political Influences and Real Earnings Management

	Hypothesis	Results
H2:	Politically influenced firms are more involved in real earnings management compared to non-politically influenced firms.	Supported
H2a:	Political influences (in presence of politician(s) on BOD) are more involved in real earnings management compared to non-politically influenced firms.	Supported
H2b:	Political influences (through significant government ownership) are more involved in real earnings management compared to non-politically influenced firms.	Supported
H2c:	Political influences (in presence of civil/military bureaucrats) are more involved in real earnings management compared to non-politically influenced firms.	Supported

Table 5.3
Summary of Hypotheses Testing for Political Influences and Earnings Aggressiveness

	Hypothesis	Results
H3:	Politically influenced firms are positively related to earnings opacity (earnings aggressiveness) compared to non-politically influenced firms.	Supported
H3a:	Political influences (in presence of politician(s) in BOD) are positively related to earnings opacity (earnings aggressiveness) compared to non-politically influenced firms	Supported

Table 5.3 (Continued)

	Hypothesis	Results
H3b:	Political influences (through significant government ownership) are positively related to earnings opacity (earnings aggressiveness) compared to non-politically influenced firms.	Supported
H3c:	Political influences (in presence of civil/military bureaucrats) are positively related to earnings opacity (earnings aggressiveness) compared to non-politically influenced firms.	Supported

Table 5.4
Summary of Hypotheses Testing for Ruling/Opposition Party Political Connections and Earnings Quality Attributes

	Hypothesis	Results
H4:	Political connections (ruling political party firms) have lower accruals quality compared to political connections from opposition political party firms.	Not Supported
H5:	Political connections (ruling political party firms) are more involved in real earnings management compared to political connections from opposition political party firms.	Not Supported and Contradicted
H6:	Political connections (ruling political party firms) are positively related to earnings opacity (earnings aggressiveness) compared to political connections from opposition political party firms.	Not Supported

Table 5.5
Summary of Hypothesis Testing for Politically Influenced firms and Substitution for Earnings Management Strategies

	Hypothesis	Results
H7:	Politically influenced firms substitute real earnings management for accruals earnings management compared to non-politically influenced firms.	Supported

5.3 Discussion

This thesis is built upon the agency theory to investigate the relationship between political influences and earnings quality. Political influences are significantly and negatively related to earnings quality. It is observed that the presence of politically influenced managers or board members creates agency cost, which in turn provides incentives to managers to report manipulated earnings in order to achieve their political gains. Agency theory elucidates the basis of conflicts and ways to curtail the conflicts that can arise between shareholders and managers (Jensen and Meckling, 1976). Agency theory also explains that the conflict between managers and shareholders occur when they have contrary interest. Managers are perceived to take decisions that capitalize on their self-interest and do not satisfy the interests of shareholders (Jensen and Meckling, 1976). This conflict causes cost to the shareholders which are known as agency cost (Watts and Zimmerman, 1990).

In respect of the research questions and objectives pertaining to the relationship between political influences and earnings quality, the current study finds out that political influences are significantly and positively related to accruals earnings management, real earnings management, and earnings aggressiveness, which implies lower earnings quality. Particularly, politically influenced firms (in presence of politician(s) on BOD, firm significantly owned by government, and in presence of civil/military bureaucrat(s) on BOD of firm) are positively and significantly related to both accruals and real earnings management. Moreover, politically influenced firms (in presence of politician(s) and bureaucrat(s) on BOD of firm) are positively and

significantly related to earnings aggressiveness. But politically influenced firms (through government ownerships) are not significantly related to earnings aggressiveness. However, Table 4.19 shows that politically influenced firms (significantly owned by government) are significantly and positively related to earnings aggressiveness, when we repeated our analysis using multiple aspects of political influences individually. Therefore, politically influenced firms have lower earnings quality.

With regard to the research question and research objective related to the political connections (through ruling/opposition party) and earnings quality, Table 4.8 and 4.13 show that the politically connected firms (through ruling party) are not significantly related to accruals earnings management and earnings aggressiveness compared to opposition party politically connected firms. Therefore, there is no difference in effect between ruling and opposition party political connections on earnings quality (when earnings quality is measured by accruals earnings management and earnings aggressiveness attributes of earnings quality). However, ruling party's political connections are significantly and negatively related to real earnings management, which is contradicted to our predicted hypothesis. It implies that opposition party politically connected firms are more engaged in real earnings management activities compared to ruling party politically connected firms. Thus, it is argued that ruling party politically connected firms have better earnings quality as compared to opposition party politically connected firms (when earnings quality is measured by real earnings management attribute of earnings quality).

In respect of the research question and research objective pertaining to examine whether politically influenced firms' substitute one earnings management strategy for the other, Table 4.11 shows that politically influenced firms substitute real earnings management for accruals earnings management.

The results of current study are grounded by the agency theory which was discussed in chapter 2. In current study, the agency theory is extended by using three aspects of political influences i.e. 1) the presence of politician(s) or their closed relative(s) in a firm; 2) the presence of civil/military bureaucrat(s) in a firm; 3) a firm is significantly owned by the government. According to the agency theory, the politically influenced manager(s) have interests contrary to those of shareholders'; in other words, managers' interests do not match with the interests of the shareholders. The managers (politically influenced) are found making decisions that protect and maximize their own interests and do not protect the interests of the shareholders. Therefore, politically influenced managers manipulate earnings to satisfy their own interests.

Hillman (2005) opines that firms build relationship with the government to get benefits, and the best way to build the relationship is to appoint a politician on the board of directors. This relationship is assumed to be able to decrease the effects of government policies, enforcements and regulations. Such relationships could improve firms' performance through protecting them from external threats and fluctuations (Hillman, 2005). Further, political influences also occur in a firm when a firm is significantly

owned by politician(s) or their close relative(s) (Cheema, Munir, and Su, 2016; Faccio, 2006). Politically influenced firms through any aspects enjoy benefits in form of low taxes, high debts and low interest rates (Saeed, Belghitar, and Clark, 2015; Faccio, Masulis, and McConnel, 2006; Fisman, 2001).

However, the association of politicians with a firm can create agency problem involving self-centered behavior by both politicians and managers (Wong, 2004). Some researchers opine that people engaged in the political process are self-centered actors who want to maximize their own interests which may curtail the interests of the majority shareholders (e.g., Buchanan and Tullock, 1968). For instance, politicians may create a connection between government agencies and managers, which may give firms a preferential access to loans and in return firms may give political donations (Hillman and Pitt, 1999).

Further, negotiation between managers and politicians could take place in order to maximize their own interest (Sheleifer and Vishny, 1994). The authors argue that when a firm is controlled by managers, politicians engaged in the firms use subsidies as bribes to influence managerial decisions in order to pursue their political objectives. Thus, the involvement of politicians in a firm can affect managerial decisions, and consequently may affect the outcomes of the firms' economic objectives. The current study looks at the earnings quality as the outcomes.

In firms where the government owned significant shareholdings, conflicts may also occur more between principal and agent (Shliefer and Vishny, 1994). In such firms, the principal-agent relationship is broken down into two other agency relationships as the government act simultaneously as principal and agent. In relation to the managers of government-owned firms, the government is a principal and thus it must assign goals (Rodriguez, Espejo, and Cabrera, 2007). The government is also the agent in its relationship with the public, the ultimate owner of the resources invested in by the government-owned firms (Ernst, 2004). The government not only considers the public interest as voters in decision making process, but also the agendas of the opposition parties that compete for votes. Therefore, the government wants to control managerial decisions so that the decisions are congruent with its political interests. The government may use its political influences to interfere with firms' operational decisions (Chen, 2004). For instance, the government may put pressure on managers to provide benefits to its supporters or stabilize employment and induce them to drift beyond profit-maximizing goals (Roe, 2003).

In addition, prior studies exemplify that the politically influenced firms can create double agency problems involving self-interested behavior by both politically influenced people and managers (Wong, 2004). Overall, the interference from the politically influenced people and government in firms may compromise the managerial autonomy, which reduce managers monitoring ability (Chen, 2004), and as a result the managers may pursue self-interest at the cost of firms' interests (Andrews and Dowling, 1998). Therefore, the managers or board members of politically influenced firms are

likely to get involved in manipulating activities, which in turn leads to poor earnings quality.

5.3.1 Political Influences and Earnings Quality

This study predicted a negative relationship between political influences and earnings quality. The results show significant and positive relationship between political influences and accruals earnings management. The study also documents that firms with politically influenced board members are more involved in real earnings management, and report aggressive earnings. Therefore, hypotheses H1 to H3 are supported. The significant findings suggest that politically influenced firms are involved in manipulating earnings through accruals and real manipulating activities. The findings of current study are consistent with the findings of prior studies that conclude that politically influenced firms are more involved in accruals earnings management (Sadiq and Othman, 2017; Chi, Liao, and Chen, 2016; Harymawan and Nowland, 2016; Al-dhamari and Ismail, 2015; Liu, Saidi, and Bazaz, 2014; Chaney, Faccio, and Parsley, 2011), real earnings management (Chi, Liao, and Chen, 2016; Braam, Nandy, Weitzel, and Lodh, 2015), and earnings aggressiveness (Sadiq and Othman, 2017; Liu, Saidi, and Bazaz, 2014; Riahi-Belkaoui, 2004). The positive relationship between political influences and earnings quality attributes indicate that the earnings quality decreases with the presence of politically influenced people in firms, which is consistent with agency theory's contention of the role of political influences in reducing the quality of earnings.

The findings for hypothesis 1 are consistent with the findings of previous studies that show the positive relationship between political influences and accruals earnings management (e.g., Harymawan and Nowland, 2016; Al-dhamari and Ismail, 2015; Chaney, Faccio, and Parsley, 2011). In addition, Chi, Liao, and Chen (2016) document that politically connected CEOs are positively related to lower level of accruals earnings manipulation. Furthermore, Chen, Ding, and Kim (2011) argue that political influences insert a new dimension to the earning generating process of firms, which makes it more complex. This complexity might increase accruals estimation errors. Other researchers opine that the accruals estimation errors is also influenced by managerial intention; and managerial intention is influenced by political factors (Bushman and Piotroski, 2006). Consequently, it results in lower accruals quality. Thus, the results of this current study taken together with evidence from prior studies confirm that politically influenced firms are more involved in accruals earnings management, and this implies lower accruals and earnings quality.

Our findings for hypothesis 2 is consistent with the findings of previous studies that show the positive relationship between political influences and real earnings management (Chi, Liao, and Chen, 2016; Braam, Nandy, Weitzel, and Lodh, 2015), because politically influenced firms want to obscure the gains that they typically derive from their connections (Chaney, Faccio, and Parsley, 2011). Recently, some researchers document that firms with politically connected CEOs are more inclined to manipulate earnings through real earnings management (e.g., Chi, Liao, and Chen, 2016). Other scholars opine that after the implementation of SOX, firms get more involved in real

earnings management (e.g., Cohen and Zarowin, 2010; Cohen, Dey, and Lys, 2008), because real earnings management is less detectable and does not come under any auditors' and regulators' jurisdictions (Braam, Nandy, Weitzel, and Lodh, 2015). In a recent study, some researchers empirically find out that politically Influenced firms substitute real earnings management for accruals earnings management (Braam, Nandy, Weitzel, and Lodh, 2015). Therefore, the results of this current study taken together with evidence from previous studies confirm that politically influenced firms are more involved in real earnings management, implies lower earnings quality.

The findings of the hypothesis 3 are consistent with the findings of previous studies that show the positive relationship between politically influenced firms and earnings aggressiveness (e.g., Ben-Nasr, Boubakri and Cosset, 2015; Liu, Saidi, and Bazaz, 2014; Riahi-Balkaoui, 2004). Ben-Nasr, Boubakri and Cosset, 2015 find out that firms with significant government ownership are positively related to high accruals. The authors suggest that the state owned firms have lower incentives to report high earnings quality. Moreover, the firms lack transparency when they have politically connected board of directors (Riahi-Balkaoui, 2004) and significantly owned by the government (Ben-Nasr, Boubakri and Cosset, 2015; Liu, Saidi, and Bazaz, 2014). Such firms that report earnings also lack transparency when they delay reporting losses and exhibit high accruals (Bhattacharya, Daouk, and Welker, 2003). Therefore, the results of this current study taken together with evidence from previous studies confirm that politically influenced firms are positively and significantly related to earnings aggressiveness relative to non-politically influenced firms.

The current study findings for Hypotheses 4 and 6 show insignificant relationship between political connections (through ruling and opposition party political connected firms) and earnings quality (when earnings quality is measured by only accruals attributes of earnings quality). These findings are not consistent with the findings of Chaney, Faccio, and Parsley (2011), which shows that ruling party's politically connected firms have poor earnings quality, because politicians remain influential even when they are not directly in power (Boubakri, Cosset, and Saffar, 2008). Our findings are also not in line with the findings of Saeed, Belghitar, and Clark (2015); Khwaja and Mian (2005), which show that amongst the politically influenced firms, those that have stronger (ruling party) political connections get more preferential treatment compared to connections with opposition party. The reason of inconsistent result is that current study includes both direct/indirect political connected firms in sample of ruling/opposition party political connected firms. Therefore, current study repeated the analysis using different sample to check the difference in effect between direct and indirect political connected firms on accruals earnings management and earnings aggressiveness. Table 4.20 and 4.22 show that politically connected firms (through direct connections) are more involved in accruals earnings management and earnings aggressiveness compared to politically connected firms through close relatives (indirect connections). Thus, there is no difference in effect between ruling party political connections and opposition party political connections on earnings quality when earnings quality is only measured by accruals attributes of earnings quality. However, political connection through direct

connections report poor earnings quality when earnings quality is measured by accruals attributes.

In addition, the findings for hypothesis 5 is contradictory to the findings of previous studies, which show that ruling party's politically connected firms' exhibit lower earnings quality compared to opposition party political connections (Chaney, Faccio, and Parsley, 2011). This study finds out that politically connected (through opposition party) firms are more involved in real earnings management, which implies that earnings quality is better among firms with stronger (ruling party) political connections compared to opposition party. The reason of contradictory findings is that Chaney, Faccio, and Parsley (2011) suggested the adoption of accruals earnings management (accruals quality) measure, whereas the current study adopted real earnings management measure for this hypothesis. Another reason of contradictory result is that current study includes both direct/indirect political connected firms in sample of ruling and opposition party political connected firms, which gives the inconsistent and contradictory results in our main results. Thus, current study repeated the analysis using different sample to check the difference in effect between direct and indirect political connected firms on real earnings management. Table 4.20 shows that politically connected firms (through direct connections) are more involved in real earnings management compared to politically connected firms through close relatives (indirect connections), which support the view that the contradictory results is due to including both direct/indirect political connected firms in sample of ruling and opposition party political connected firms .

Therefore, the results from our repeated analyses for hypotheses 4 and 6 are consistent with the findings of Chaney, Faccio, and Parsley (2011), who suggest that stronger political connections or political connections through direct connections (presence of politicians) are more involved in accruals earnings management and reporting aggressive earnings. In addition, the results from our repeated analysis for hypothesis 5 suggest that weaker political connections or political connections through indirect connections (presence of closed relatives of politicians) are more involved in real earnings management.

Hypothesis seven predicts that politically influenced firms substitute real earnings management for accruals earnings management compared to non-politically influenced firms. The finding is in tandem with those of Braam, Nandy, Weitzel, and Lodh (2015); Zang (2011); Cohen and Zarowin (2010); Cohen, Dey, and Lys (2008), who state that firms substitute real earnings management for accruals earnings management to reduce risk of detection. In addition, using multiple-countries data the study of Braam, Nandy, Weitzel, and Lodh (2015) find out that politically influenced firms are likely to substitute real earnings management for accrual-based earnings management when the risk of detection increases. Other scholars opine that politically connected CEOs are more involved in higher level of real earnings management compared to lower level of accruals earnings management (e.g., Chi, Liao, and Chen, 2016).

The current study findings for Hypotheses seven are congruent with the findings of previous studies that show the negative relationship between the interaction effect of political influences and accruals earnings management (i.e. PIAEM) on real earnings management (Braam, Nandy, Weitzel, and Lodh, 2015). Therefore, the results of this current study taken together with evidence from previous studies confirm that politically influenced firms' substitute real earnings management for accruals earnings management.

CHAPTER SIX

CONCLUSION

6.1 Contributions of the Study

6.1.1 Theoretical Contributions

The findings of the previous studies together with the current study indicate that agency theory explains the relationship between political influences and earnings quality. The findings of the current study are consistent with the findings of prior studies, which document that politically influenced firms are involved in accruals earnings management (Chi, Liao, and Chen, 2016; Al-dhamari and Ismail, 2015; Liu, Saidi, and Bazaz, 2014; Chaney, Faccio, and Parsley, 2011), real earnings management (Chi, Liao, and Chen, 2016; Braam, Nandy, Weitzel, and Lodh, 2015), and earnings aggressiveness (Liu, Li, Zeng, and An, 2016; Riahi-Balkaoui, 2004), implies lower earnings quality. Further, the findings of the current study document that there is no difference in effect between ruling/opposition party political connections and earnings quality (when earnings quality is measured only by accruals attributes of earnings quality).

However, politically connected firms through opposition party are more involved in real earnings management, which implies that they are reporting poorer quality of earnings compared to political connections through ruling party. Notably, these findings are one of the main contributions of the current study to the body of literature of political influences and earnings quality. While previously, some authors have suggested that politically connected firms through ruling party are more involved in earnings management (Chaney, Faccio, and Parsley, 2011). The current study findings are

contrary to the findings of Chaney, Faccio, and Parsley (2011), because they only employed accruals attributes of earnings quality, whereas the current study has employed both accruals and real earnings management attributes of earnings quality. Hence, current study suggests that the types of political influences and earnings quality need to be specified clearly and precisely.

The current study was motivated to investigate the relationship between political influences and earnings quality, because Pakistan is famous for its close and doubtful relationship between firms and politicians (Khwaja and Mian, 2005). Over the last 25 years, three elected governments were dissolved on corruption allegations and political abuse of power. Because of the weak government institutions, the Pakistani business environment looks particularly weak to political connections (Cheema, Munir, and Su, 2016). Pakistan has many politically influenced listed firms; however, there are no restrictions to such political connections (Saeed, Belghitar, and Clark, 2015). Such features of the Pakistani economy gave an attractive platform to examine the effect of political influences on firms' earnings quality. Recently, some scholars also opine that political influences and earnings quality need to be investigated in a more detail (e.g., Chi, Liao, and Chen, 2016; Al-dhamari and Ismail, 2015; Zeng, Li, and Hong, 2012).

To the best of the researcher's knowledge, limited studies have used multiple aspects and attributes of political influences and earnings quality respectively, no extant literature has examined the relationship between political influence and earnings quality using three aspects of political influences (as measured by significant government

shareholdings; presence of politician(s) or close relative(s) of a politician(s) in a firm; and presence of current/retired military/civil bureaucrat(s) in a firm) and three attributes of earnings quality (as measured by accruals earnings management, real earnings management, and earnings aggressiveness). The current study has found significant and negative relationship between political influences and earnings quality. In addition, most of the previous studies have used multiple countries' data, while current study has used Pakistani data, which overcomes some criticisms of multiple-countries studies.

Moreover, to provide more detailed investigations between political influences and earnings quality, the researcher has given more insight into the effects of ruling/opposition party's political connections on earnings quality attributes. The present study also contributes by testing the difference in effect between direct and indirect political connections on earnings quality. Therefore, an important contribution of this study to the existing literature of political influences and earnings quality is that it offers more detailed empirical insights using data from a less-studied and less-regulated environment i.e. South Asia (specifically Pakistan).

Furthermore, while previous studies (e.g., Chi, Liao, and Chen, 2016; Braam, Nandy, Weitzel, and Lodh, 2015) on political influences and earnings quality have investigated the relationship between political influences and earnings management strategies (i.e. accruals and real earnings management) using single aspect of political influences. However, the present study investigated the relationship between political influences (using three aspects) and both strategies of earnings management. The study further

contributes by investigating whether politically influenced firms substitute between earnings management strategies to avoid detections, which to the best of this researcher's knowledge previous studies had only investigated using single aspect of political influences.

Similarly the study contributes theoretically to political influences and earnings quality by investigating how politically connected people influence firms to report poor quality of earnings. The findings of the current study also suggest that it does not matter if firms are directly or indirectly connected to the ruling party or the opposition party, all connected firms on any mentioned criteria have reported lower quality of earnings. Thus, the findings of the current study give insights that the political influences through any means would provide incentives to the managers and weaken the earnings quality.

6.1.2 Practical Contributions

The findings of the current study offer recommendations especially to the financial and economics regulatory bodies i.e. Securities and Exchange Commission of Pakistan (SECP) and State Bank of Pakistan (SBP), policymakers and other regulatory authorities such as Federal Board of Revenue (FBR), National Accountability Bureau (NAB), and Federal Investigation Agency (FIA). From a policy perspective, the study empirically reveals that politically influenced firms are manipulating earnings through accruals and real earnings management activities and reporting lower earnings quality. The presence of politically influenced people in a firm provides incentives and

influence managers decision, which compromise the objectives of the board and management and leads to an undesirable reporting of lower quality of earnings.

Securities and Exchange Commission of Pakistan (SECP) plays an important role to stop or minimize the reporting of lower earnings quality. First, as a regulatory authority, SECP should direct firms to disclose their politically connected directors and enforce other non-politically influenced directors to not compromise on their responsibilities. Second, current study's' findings can awaken BIG4 auditors, though they are negatively related to accruals earnings manipulations, but positively related to real earnings manipulations. It means BIG4 auditors often fail to stop or minimize real manipulating activities. Therefore, SECP can direct auditors to detect real earnings manipulation activities of firms, which could prevent politically influenced firms from real earnings management and substitution of earnings management strategies.

Furthermore, future regulatory efforts should consider examining earnings manipulating activities of politically influenced firms to make politically influenced firms more accountable. For example, SECP should take serious disciplinary measures to improve governance activities such as increasing the number of independent directors on board and audit committee, enhancing the independence of other non-politically influenced board members. SECP could also ask firms to disclose the presence of current/former politician(s) and bureaucrat(s) on board of directors and it should not be increased to majority board members.

Moreover, the findings of the current study suggest that the other non-politically influenced board members have failed to perform their duties in politically influenced firms. Therefore, it is essential for SECP to provide training programs, and ensure that the training programs are attended by independent or non-politically influenced board members to successfully perform their duties. The results of this study suggest that only enforcing good governance activities is not enough to enhance the earnings quality. Therefore, regulators should also offer enlightenment programs on shareholder activism.

Politically influenced firms manipulate earnings to hide their political gains. As discussed earlier in Chapter 2, presence of politically influenced people on board creates agency problem or costs, which will result in lower quality of earnings. Hence, to reduce these costs, strong regulatory bodies and enlightened shareholders are needed. The results of current study enable shareholders and other potential investors to evaluate the negative effects of politically influenced directors on reporting earnings quality. This will help shareholders or investors to protect their interests and put pressure on directors to report un-manipulated earnings. Furthermore, other stakeholders can use the findings of the current study to identify which factors should be taken into consideration when evaluating a firms' earnings quality. The results of the current study suggest that political influences create the agency problem and, accordingly, diminish the earnings quality (by engaging in accruals and real earnings management, and reporting less transparent earnings (earnings aggressiveness), and substituting real earnings

management for accruals earnings management). Therefore, corporate political influences and connections should be taken into consideration in the valuation process.

The findings of the current study further add in setting up the foundation that agency theory explains the relationship between political influences and earnings quality in Pakistan and worldwide. The findings in this study also document that there is no difference in effect of ruling/opposition party political connection on earnings quality (when earnings quality is measured by accruals measures only), however, politically connected firms through opposition parties are more involved in real earnings management. Therefore, this study provides evidence to the academic research that firms connected with opposition parties have poorer earnings quality compared to the firms connected with the ruling party. Instead of focusing solely on the impact of politically influenced firms on earnings quality (using three attributes), this study gives evidence that ruling/opposition party also significantly strengthens this relationship. Moreover, the current study also focuses on the impact of direct/indirect political connections on earnings quality (using three attributes). Thus, the agency cost in political influences and earnings quality literature should extend to other developing and under-developing economies in future.

6.2 Limitations of the Study

Like any other research, the results of the current study have shown potential limitations, which readers must be aware of while interpreting the findings. The limitations of the current study are discussed below:

1. First, the current study provides a detailed investigation on the relationship between political influences and earnings quality, though, this study employs three earnings quality attributes, but does not consider other earnings quality attributes such as earnings conservatism, value relevance, earnings persistence etc.

2. Secondly, there are a few such internal and external factors that may influence the quality of reporting earnings but are not included in the current study such as internal control system, corporate governance, audit committee characteristics, internal audit, firm specific characteristics, corporate social responsibility, tax and non-tax regulations, and capital requirements etc. However, the purpose of this study is to investigate the relationship between political influences and earnings quality in more detail, and therefore, the impact of this limitation on the results cannot be a major concern.

3. The choice of earnings quality attributes and their proxies limits the strength of the evidence provided in the current study. So far, there is no consensus on the definition of earnings quality and measurement of various earnings quality attributes, and thus the chosen earnings quality attributes and their proxies have the potential to exhibit measurement errors. However, to reduce the effects of this limitation, current study adopts various alternative measures of earnings quality (earnings management), and the results largely remain unchanged.

4. The results of the current study may not be applicable to other developed economies with strong regulatory bodies and institutes, with higher investor protection and lower corruption. The conflict of interest law in developed economies is strongly implemented compared to developing economies. Therefore, politically influenced firms in developed economies might not be able to get political gains and manipulate earnings to hide these gains.

5. Because of the lack of prior studies concerning the effect of political influences (using three aspects simultaneously) on earnings quality attributes (particularly real earnings management), the current study has tried to compare the results of this study with those of accruals attributes of earnings quality. This may not be appropriate as both accruals and real earnings manipulating are two different attributes of earnings quality.

6. Finally, current study has generated its own list of politically influenced firms, where the selection of politically influenced firms was based on predetermined criteria mentioned in chapter three. Thus, current study might miss some politically influenced firms, because not all politicians in Pakistan disclose their wealth, and they probably plan their investments through their front man. However, current study does not have the evidence to declare such firms as politically influenced firms, and hence they have been excluded from the sample of this study.

6.3 Future Research

The limitations discussed in previous section could be an opportunity for future research.

1. Another avenue of future research could be to examine the interaction effect of political influences and corporate governance on earnings quality attributes. It would be of interest for future researchers to investigate whether good governance practices can reduce the negative effects of political influences on earnings quality.

2. In order to make a more detailed investigation, future research can examine the effects of political influences on earnings quality using other attributes (i.e. earnings persistence, earnings informativeness, and value relevance etc.). In addition, future study can also add another dimension to politically influenced firms, by investigating whether there is difference in effect between winning/losing party political connections on earnings quality, despite connections to ruling or opposition party.

3. Another opportunity for future research could be to investigate whether politically influenced firms manipulate earnings to report under/over-performance. It is interesting to examine the interaction effects of political

influences and earnings management strategies (i.e. accruals earnings management and real earnings management) on organizational performance.

4. Future research can also replicate the current research while using the data from other developing economies (e.g. Bangladesh, India, Srilanka, Indonesia, and China etc.). It is worthy to investigate for future research whether politically influenced firms in these countries report lower earnings quality.

5. Finally, current study has used quantitative research approach (using secondary data) in this study. Future research can also use primary data and qualitative research approaches to explore and investigate the relationship between political influences and earnings quality in more detail. These approaches could identify how politically influenced board members influence other board members and what exactly motivates them to manipulate earnings and report lower earnings quality.

6.4 Conclusion

This chapter provides a detailed summary of all the chapters in this research, starting with the introductory chapter one, and the chapters on research methodology, literature review and findings of the study. Consistent with prior studies, current study provides evidence that politically influenced firms in Pakistan are significantly and positively related to accruals earnings management, real earnings management, and earnings

aggressiveness. This implies that politically influenced firms in Pakistan are reporting lower quality of earnings compared to non-politically influenced firms.

In addition, this study indicates that politically connected firms (through opposition party) in Pakistan are more involved in real earnings management compared to ruling party politically connected firms, implying lower earnings quality. Furthermore, politically influenced firms in Pakistan substitute real earnings management for accruals earnings management strategy.

Overall, four out of the seven hypotheses were found to be supported. These findings serve as alarm to the regulatory bodies and enforcing firms to adopt good governance practices and report higher earnings quality. The findings also highlight the need of implementing conflict of interest law, strong institutions which can prevent politically influenced firms from manipulating earnings, provide awareness to shareholders, and other stakeholders. The findings also provide awareness to the potential investors in Pakistan that political influences is one of the main factor, which need to consider before making any investment.

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APPENDIX A: List of firms used in the current study

S.No	Firms	Status
1	Asim Textile Mills Ltd.	PI
2	Chenab Ltd.	PI
3	Dewan Farooque Spinning Mills Ltd.	PI
4	Dewan Khalid Textile Mills Ltd.	PI
5	Dewan Mushtaq Textile Mills Ltd.	PI
6	Dewan Textile Mills Ltd.	PI
7	Kohat Textile Mills Ltd.	PI
8	Mahmood Textile Mills Ltd.	PI
9	Masood Textile Mills Ltd.	PI
10	Nishat (Chunian) Ltd.	PI
11	Nishat Mills Ltd.	PI
12	Saif Textile Mills Ltd.	PI
13	Service Industries Textiles Ltd.	PI
14	Bannu Woollen Mills Ltd.	PI
15	Al-Noor Sugar Mills Ltd.	PI
16	Dewan Sugar Mills Ltd.	PI
17	Haseeb Waqas Sugar Mills Ltd.	PI
18	JDW Sugar Mills Ltd.	PI
19	Khairpur Sugar Mills Ltd.	PI
20	Mirza Sugar Mills Ltd.	PI
21	Noon Sugar Mills Ltd.	PI
22	Sanghar Sugar Mills Ltd.	PI
23	Shakarganj Mills Ltd.	PI
24	Tandlianwala Sugar Mills Ltd.	PI
25	Noon Pakistan Ltd.	PI
26	Berger Paints Pakistan Ltd.	PI
27	Biafo Industries Ltd.	PI
28	Fauji Fertilizer Bin Qasim Ltd.	PI
29	Fauji Fertilizer Co. Ltd.	PI
30	Sanofi-aventis Pakistan Ltd.	PI
31	Khyber Tobacco Co. Ltd.	PI
32	Pakistan Engineering Co. Ltd.	PI
33	Pakistan Tobacco Co. Ltd.	PI
34	Service Industries Ltd.	PI
35	Treet Corporation Ltd.	PI
36	Tri-Pack Films Ltd.	PI
37	Attock Cement Pakistan Ltd.	PI
38	D.G. Khan Cement Co. Ltd.	PI
39	Dewan Cement Ltd.	PI

S.No.	Firms	Status
40	Fauji Cement Co. Ltd.	PI
41	Maple Leaf Cement Factory Ltd.	PI
42	Thatta Cement Ltd.	PI
43	Dewan Farooque Motors Ltd.	PI
44	Ghandhara Industries Ltd.	PI
45	Ghandhara Nissan Ltd.	PI
46	The General Tyre and Rubber Co. of Pak Ltd.	PI
47	K-Electric (formerly KESC)	PI
48	Sitara Energy Ltd.	PI
49	Southern Electric Power Co. Ltd	PI
50	Sui Northern Gas Pipelines Ltd.	PI
51	Kot Addu Power Co. Ltd.	PI
52	Mari Petroleum Co. Ltd.	PI
53	Oil and Gas Development Co. Ltd.	PI
54	Sui Southern Gas Co. Ltd.	PI
55	Pakistan National Shipping Corporation.	PI
56	Pakistan Telecommunication Co. Ltd.	PI
57	Worldcall Telecom Ltd.	PI
58	Attock Petroleum Ltd.	PI
59	Attock Refinery Ltd.	PI
60	National Refinery Ltd.	NPI
61	Pakistan Oilfields Ltd.	PI
62	Pakistan Petroleum Ltd.	PI
63	Pakistan Refinery Ltd.	NPI
64	Pakistan State Oil Co. Ltd.	PI
65	Packages Ltd.	PI
66	Siemens (Pakistan) Engineering Co. Ltd.	NPI
67	Pace (Pakistan) Ltd.	PI
68	Ahmed Hassan Textile Mills Ltd.	NPI
69	Al-Qadir Textile Mills Ltd.	NPI
70	Ali Asghar Textile Mills Ltd.	NPI
71	Allawasaya Textile and Finishing Mills Ltd.	NPI
72	Apollo Textile Mills Ltd.	NPI
73	Artistic Denim Mills Ltd.	NPI
74	Bhanero Textile Mills Ltd.	NPI
75	Kohinoor Mills Ltd.	NPI
76	Kohinoor Spinning Mills Ltd.	NPI
77	Kohinoor Textile Mills Ltd.	NPI
78	N.P. Spinning Mills Ltd.	NPI
79	Premium Textile Mills Ltd.	NPI
80	Quetta Textile Mills Ltd.	NPI

S.No.	Firms	Status
81	Sapphire Textile Mills Ltd.	NPI
82	Abdullah Shah Ghazi Sugar Mills Ltd.(Al-Asif Sugar Mills Ltd	NPI
83	Adam Sugar Mills Ltd.	NPI
84	Al-Abbas Sugar Mills Ltd.	NPI
85	Habib - ADM Ltd.(Habib Arkady LTD.)	NPI
86	Habib Sugar Mills Ltd.	NPI
87	Mehran Sugar Mills Ltd.	NPI
88	Mirpurkhas Sugar Mills Ltd.	NPI
89	Shahmurad Sugar Mills Ltd.	NPI
90	The Thal Industries Corporation Ltd.	NPI
91	Ismail Industries Ltd.	NPI
92	Murree Brewery Co. Ltd.	NPI
93	National Foods Ltd.	NPI
94	Nestle Pakistan Ltd.	NPI
95	Rafhan Maize Products Co. Ltd.	NPI
96	Shezan International Ltd.	NPI
97	Abbott Laboratories (Pakistan) Ltd.	NPI
98	Colgate-Palmolive (Pakistan) Ltd.	NPI
99	Glaxosmithkline (Pakistan) Ltd.	NPI
100	Highnoon Laboratories Ltd.	NPI
101	ICI Pakistan Ltd.	NPI
102	Searle Pakistan Ltd.	NPI
103	Eco Pack Ltd.	NPI
104	International Industries Ltd.	NPI
105	Philip Morris (Pakistan) Ltd.	NPI
106	Thal Ltd.	NPI
107	Karam Ceramics Ltd.	NPI
108	Flying Cement Co. Ltd.	NPI
109	Lafarge Pak. Cement Ltd.	NPI
110	Lucky Cement Ltd.	NPI
111	Kohat Cement Co. Ltd.	NPI
112	Agriauto Industries Ltd.	NPI
113	Atlas Battery Ltd.	NPI
114	Baluchistan Wheels Ltd.	NPI
115	Sazgar Engineering Works Ltd.	NPI
116	Kohinoor Energy Ltd.	NPI
117	Altern Energy Ltd.	NPI
118	Japan Power Generation Ltd.	NPI
119	The Hub Power Co. Ltd.	NPI
120	Hum Network Ltd.	NPI
121	TRG Pakistan Ltd.	NPI

S.No.	Firms	Status
122	Pakistan Int. Container Terminal Ltd.	NPI
123	Telecard Ltd.	NPI
124	Byco Petruleum (Bosicor Pakistan Ltd.)	NPI
125	Shell Pakistan Ltd.	NPI
126	Security Papers Ltd.	NPI
127	Pakistan Cables Ltd.	NPI
128	Shifa International Hospitals Ltd.	NPI
129	Zeal Pak Cement Factory Ltd.	NPI

Key: PI – Politically Influenced Firms; NPI – Non-Politically Influenced Firms.